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CONTENTS

TUESDAY, FEBRUARY 15, 1983

Page

Prepared statement of Hon. Mark O. Hatfield, U.S. Senator from Oregon 1
Prepared statement of Hon. John C. Stennis, U.S. Senator from Mississippi 2

DEPARTMENT OF THE TREASURY

Statement of Hon. Donald T. Regan, Secretary of the Treasury 3
Prepared statement 10
Questions submitted by Chairman Hatfield 63
Questions submitted by Senator Stennis 70
Questions submitted by Senator Leahy 72

WEDNESDAY, FEBRUARY 16, 1983

COUNCIL OF ECONOMIC ADVISORS

Statement of Dr. Martin Feldstein, Chairman, President's Council of Economic Advisors 77
Prepared statement 85
Questions submitted by Chairman Hatfield 111
Questions submitted by Senator Stennis 112
Questions submitted by Senator Leahy 113

CONGRESSIONAL BUDGET OFFICE

Statement of Dr. Alice Rivlin, Director, Congressional Budget Office 115
Prepared statement 122
Questions submitted by Chairman Hatfield 140
Questions submitted by Senator Stennis 144
Questions submitted by Senator Leahy 145

TUESDAY, FEBRUARY 22, 1983

OFFICE OF MANAGEMENT AND BUDGET

Statement of David A. Stockman, Director, Office of Management and Budget 149
Charts on economic and fiscal issues 156
Questions submitted by Chairman Hatfield 219

NONDEPARTMENTAL WITNESSES

Statement of Dr. Alan Greenspan, president, Townsend-Greenspan, Inc 237
Statement of Dr. George L. Perry, senior fellow, The Brookings Institution 240
Prepared statement 241

ECONOMIC OVERVIEW FOR FISCAL YEAR 1984

TUESDAY, FEBRUARY 15, 1983

U.S. SENATE,
COMMITTEE ON APPROPRIATIONS,
Washington, D.C.

The committee met at 9:30 a.m. in room SD–192, Everett McKinley Dirksen Senate Office Building, Hon. Mark O. Hatfield (chairman) presiding.

Present: Senators Hatfield, Weicker, Abdnor, Mattingly, Rudman, Specter, Stennis, Chiles, Leahy, and Bumpers.

COMMITTEE ON APPROPRIATIONS

MEMBERS' OPENING STATEMENTS

PREPARED STATEMENT

Chairman HATFIELD. It is my pleasure to open the Economic Overview hearings of the Committee on Appropriations for the third consecutive year. I am going to have my formal statement placed in the record.

[The statement follows:]

PREPARED STATEMENT OF HON. MARK O. HATFIELD, U.S. SENATOR FROM OREGON

It is my pleasure to open Economic Overview hearings of the Committee on Appropriations for the third consecutive year.

This year's hearings open at a time of renewed hope for our economy and for those millions who have suffered from its recessionary weakness, and yet at a time of profound concern about some of the economic realities facing us. On the plus side, inflation has been reduced to the lowest level in a decade, and a recovery from the deepest recession since the 1930's is reflected in a broad number of economic indicators.

On the negative side, even with the January improvement, the Nation's unemployment rate was an unacceptably high 10.4 percent, or 10.2 percent if our Armed Forces are included. In addition, we face by far the largest deficit figure in U.S. history, even with a robust recovery.

This committee has made its reputation and contribution to our Government over the years by reducing the spending requests of the executive branch, and thereby reducing the Federal deficit. Until the Reagan administration's sharply reduced spending requests, there was but 1 or 2 years in 4 decades that we did not enact appropriations levels below Presidents' requests. To put our present predicament in perspective, during all those years, a total of $180 billion in budget authority was cut from the President's budget. In the single year of fiscal year 1984, even if we enact all the President's deficit-reducing proposals, we will have a deficit estimated at $189 billion, greater than our 40 years of savings.

The blame for our current plight certainly does not rest with this committee or the

appropriations process. It rests with the recession; with the dramatic growth of uncontrollable spending outside this committee's purview; with the administration's massive 5-year $1.6 trillion defense program; and with the Economic Recovery Tax Act of 1981, which eroded Government revenues by $864 billion over the fiscal year 1982–86 period.

And we have no respite as we look ahead. As Dr. Alice Rivlin warned us at last year's hearing, the budgetary outlook has changed drastically. As we looked ahead in past years, revenues would rise faster than outlays as the income tax brought in more revenue under the impact of a growing and inflationary economy. At the end of this rainbow was a budgetary surplus. Now, future budgets are horribly out of balance. By the administration's calculation, the fiscal year 1988 deficit will be $300 billion, unless changes are made, or the economy improves more than anticipated.

The one blessing in this bleak picture is that we know the magnitude of the job facing us; we cannot be lulled into a false sense of impending Nirvana. We must reduce the deficit. While doing so, however, we must not turn our backs to the millions of Americans idled by the recession, or on America's other disadvantaged citizens. A fair and compassionate Government must help them. It will be Congress most difficult task in the coming year to properly balance these needs.

I have scheduled 3 days of hearings to pursue these and other questions with both Government and non-Government spokesmen. Today our witnesses will be Donald Regan, Secretary of the Treasury followed by Dr. Martin Feldstein, the President's new Chairman of the Council of Economic Advisers, both of whom will present the President's perspective on our economic situation. Tomorrow we will look at it from the view of the Congressional Budget Office, as Dr. Alice Rivlin unveils CBO's reanalysis of the budget. Finally, on February 22, one week from today, we will hear from OMB Director David Stockman, and from two non-governmental economists, Dr. Alan Greenspan, former Chairman of the Council of Economic Advisers and Dr. George Perry of the Brookings Institution.

PREPARED STATEMENT

Chairman HATFIELD. Mr. Secretary, first of all, are there any opening comments any of the members wish to make?

Senator STENNIS. Mr. Chairman, I have brief remarks if I may put them in the record, please.

Chairman HATFIELD. Without objection.

[The statement follows:]

PREPARED STATEMENT OF HON. JOHN C. STENNIS, U.S. SENATOR FROM MISSISSIPPI

Mr. Chairman, I am again pleased that you have called these meetings of our committee to get a firsthand overview of the economy and the President's proposals for a budget. These sessions are enormously helpful to me as we begin deliberations on the President's budget proposals and those other legislative matters which affect the economy. As the chairman is aware, economic conditions have steadily worsened over the past few years. The stagnancy in our economy has not positively responded to the efforts of the administration. This recession has taken an especially heavy toll on the spirits of working people. Many highly productive American workers have become aware that their jobs are subject to economic forces beyond their personal control.

We must be thankful, Mr. Chairman, that we have in place unemployment compensation and other assistance programs to mitigate against the extreme deprivation which we experienced once before during the Great Depression. There are reports that business activity is picking up. It is my hope that this activity will build and turn into a positive trend.

In this regard, I am greatly concerned that the outlook for the deficit may cause interest rates to surge again and cut off a recovery. I ask that each of the experts who appear before us address this matter. I feel very strongly that we cannot abandon a fiscally responsible course which will lead to a balanced budget. It cannot be done in one year, I know, but I believe we have the responsibility to set a level of spending and revenues which would achieve a balanced budget when the economy achieves full output.

DEPARTMENT OF THE TREASURY

SECRETARY OF THE TREASURY

STATEMENT OF THE HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

STATEMENT SUMMARY

Chairman HATFIELD. Mr. Secretary, I apologize. I was fouled up with my schedule here this morning. I am sorry to keep you waiting. We will save the time of formal opening statements and go directly to you. I know that you have appeared on the Hill many times during the preliminaries to this session. It has always been very helpful to have your testimony, as the President's chief economic spokesman. I am going to ask you to proceed by either summarizing your testimony or reading it as you wish.

Secretary REGAN. Thank you, Mr. Chairman. I have a summary of my remarks which I will proceed to read now and submit the entire statement for the record.

It is a pleasure to meet with you today and to discuss the administration's 1984 budget proposals.

The recession now appears to be over, and the fundamental elements of recovery are now largely in place. There has been clear progress on inflation, and consumer price growth has dropped dramatically from 12.4 percent in 1980 to 3.9 percent in 1982. Producer prices posted a 1-percent drop in January, the largest in the history of the index. Interest rates, which had been driven to record levels by inflation, are down from peak levels of 21½ percent on the prime in December 1980 to 11 percent currently. Real wage growth is being restored.

SIGNALS OF AN ECONOMIC UPTURN

There are clear signals that the recession is now behind us. To summarize these signals: the employment rate for the civilian labor force fell sharply from 10.8 percent in December to 10.4 percent in January; the index of leading indicators has risen for 8 out of the last 9 months; housing is in the midst of a rapid recovery; business trimmed inventories sharply in the final quarter of last year. Historically, a cleanout of inventories has been followed by higher rates of production; retail sales have begun to firm; total industrial production stabilized in December, and, evidence available on employment and workhours in January indicates that production will almost certainly rise for the month.

THE TYPICAL RECOVERY

We would all hope for a vigorous recovery, not unlike those which occurred in the past. The typical postwar recovery path is shown in the first chart, which is chart 3 of the submitted testimony. Excluded from this chart are two atypical recoveries, the first of which included the Korean War buildup and the second which got underway late in 1980 but was short-lived.

The five recoveries contained in the average line on the chart were remarkably similar. Gains over the first eight quarters from the real GNP trough were within an extremely narrow range of 5 to 6 percent at an annual rate.

The contributions of GNP components to real growth during the typical recovery are shown in the second chart, which is chart 4 of the testimony submitted. As it indicates, much of the initial thrust for expansion comes from: A resurgence in homebuilding activity, such as currently is underway; a swing in inventory investment from decumulation in the latter stages of recession to accumulation; and, a major contribution from consumer spending, with purchases of consumer durables registering particularly large increases.

By contrast, Federal spending normally declines as a share of GNP during recovery, and is not necessary for promoting expansion.

OUTLOOK FOR THE ECONOMY

A vigorous recovery of the type outlined would be most welcome. It would certainly help ease the Nation's budgetary problems. However, we recognize that the serious problems still confronting us may well hold growth during the next year or two below the typical recovery pattern.

The administration's official forecast contains a fairly conservative estimate of real growth at a 3.1-percent rate during the four quarters of 1983, rather than the typical recovery growth rate of about twice that much.

POLICIES FOR RECOVERY

In setting policy for the remainder of the eighties, we must recognize what we must not do. We must not revert back to the overly stimulative monetary and fiscal policies pursued at times in the past, for these would surely lead to a resurgence of inflation and a new round of rising interest rates.

Further, we must not reverse the fundamental tax restructuring put in place in 1981, for this was designed to provide the noninflationary incentives without which the private sector would continue to wither.

Spending reduction will contribute to the recovery, and the recovery will contribute to deficit reduction. The deficit will fall as the economy advances, particularly if the recovery is a vigorous one. A strong recovery with $1\frac{1}{3}$ percent more real growth per year than in our forecast would bring the budget to near balance by 1988, provided we also curb the growth of Federal outlays.

However, if we fail to bring spending under control and if recovery is slow, we will face a deficit problem which is larger and longer-lasting than we can afford.

DEFICIT REDUCTION PROGRAM ELEMENTS

The deficit reduction program that we propose contains four basic elements. First, there is a freeze on 1984 outlays in real terms. The 6-month freeze on COLA's, as recommended by the Social Security Commission, is to be extended to other indexed programs. There will be a 1-year freeze on pay and retirement of Federal workers, both civilian and military.

The second element of our budgetary program contains measures to control the so-called uncontrollables, taking special care to protect those truly in need.

The third element is a cutback of $55 billion in defense outlays from original plans.

Fourth is a set of proposals involving the revenue side of the budget.

UNIFIED BUDGET RECEIPTS UPTURN

There has been a gradual upward trend in unified budget receipts as a percent of gross national product. as shown on the top line of the next chart, which is chart 5 of the submitted testimony.

As shown in the bottom line of the chart, a major shift in the composition of receipts has been the rising share of social insurance and other payroll taxes to fund social security and other retirement benefits.

No major tax increases will be proposed for the years 1983 and 1984, and the President is committed to retaining the third year of the tax cut and the indexing provision beginning in 1985.

In addition, the President has directed the Treasury Department to undertake a long-term study of ways to simplify the Federal tax system.

1981 TAX CUT

I want to discuss briefly the tax cut enacted in 1981 and address some of the misconceptions about the act, namely, that the tax cut was much too large and as a result, it destroyed our revenue base and caused the budget deficits we are facing.

Rather than being too large, the tax cut enacted in 1981 just barely offsets the rising tax burden on the economy.

Between fiscal 1981 and fiscal 1988, ERTA, the Economic Recovery Tax Act of 1981, reduces taxes by $1.138 trillion, a substantial amount. But a substantial tax cut is needed to offset the equally substantial tax increases facing the American taxpayers between fiscal 1981 and 1988.

Last summer's tax bill raises taxes by $281 billion. The gasoline bill, which goes into effect on April 1, raises taxes by $21 billion. Inflation-induced bracket creep raises taxes by $489 billion over this period.

Previously scheduled social security taxes raise taxes by $214 billion, and the proposed bipartisan social security rescue plan will raise an additional $56 billion.

So the total tax increases amount to $1.061 trillion, leaving the taxpayers with a net tax cut of only $77 billion between 1981 and 1988.

Rather than destroying the tax base, as many have suggested, the 1981 tax cut merely "returns revenues as a percentage of GNP to approximately the levels that prevailed in the sixties and seventies," and

that is according to the Congressional Budget Office's recent report on the budget.

Under the administration's budget, taxes as a percent of gross national product for fiscal years 1983 to 1986 will average 19.2 percent. This is a level slightly higher than the 18.6 percent average for the sixties and the 18.9 percent average for the seventies. It is low only in comparison to the high tax level of the previous administration, which reached 20.9 percent in fiscal year 1981.

As the CBO points out, the tax burden during the eighties, and I quote, "would have moved well above the alltime record of 21.9 percent of GNP reached in 1944" without the tax cuts.

The CBO also reports that due to the tax cut, individual income taxes, as a percent of taxable personal income, will average 12.3 percent for 1948 to 1988. This is a level below the 14.3 percent of 1981, which was the highest level in history, but close to the 12.2 percent average for the late seventies.

Without the tax cut, the CBO notes, the tax rate would have risen to an unprecedented 18.4 percent of taxable personal income by 1988. If indexing is repealed, the tax rate will rise to a near record level of almost 14 percent of taxable personal income by 1988.

Repeal of the remainder of the tax cut would strike disproportionately at lower income workers and retirees. Seventy-two percent of the benefits of the third-year tax cut goes to those earning less than $50,000 a year. Repeal of the third year would cause a 13.9-percent jump in tax liability for those with less than $10,000 of adjusted gross income, a 12-percent jump for those between $20,000 and $30,000, and only a 2.7-percent jump for those with $200,000 and over.

INDEXING

The unfairness of repeal is even more pronounced with indexing. Seventy-eight percent of the benefits of indexing goes to those earning less than $50,000 a year. Assuming 4.5 percent inflation, repealing indexing would produce a 9.4-percent jump in the tax liability for those with less than $10,000 in adjusted gross income, a 3.3-percent jump for those between $20,000 and $30,000; and a 0.5-percent jump for those with $200,000 and over.

Even worse, these latter increases from repeal of indexing would be repeated each year as long as inflation continues.

Indexing is of relatively greater importance to the lower tax brackets. First, the lower brackets are narrowest in percentage terms, and inflation causes income to rise through the brackets fastest at the bottom.

Second, for those in the lower brackets, personal exemptions and the zero bracket are large relative to total income. Indexing keeps these exemptions from losing real value and keeps inflation from pushing those too poor to owe tax onto the tax rolls.

Third, upper income tax payers may already be in the top tax bracket, with no higher bracket into which to be pushed.

EFFECT ON SMALL BUSINESS OF TAX CUTS

In addition to the significance for individuals of the third year cut and indexing, both of these measures are of critical importance to small businesses. Small businesses tend to be labor intensive, and the administration's program of reducing marginal tax rates and indexing will help limit wage pressures, enabling American labor to maintain competitiveness with workers overseas.

In addition, because over 85 percent of small businesses pay only personal income tax, the administration's tax program will help directly to safeguard the value of their earnings.

RETIREMENT COLA'S

There have been suggestions that proposals to delay retirement COLA's or pay increases should be accompanied by repeal of the third year or indexing to increase fairness, as if these proposals somehow impact different groups.

In fact, this would impose an unfair double burden on workers, savers, and pensioners of all income levels who are simultaneously income recipients and taxpayers.

We are asking social security recipients to accept a 6-month delay in their cost-of-living increase, and the taxation of a portion of benefits for upper income retirees, to help save the social security system.

It would be unfair to raise tax rates on their other pension or interest income by repealing the third year, or to subject their fixed retirement incomes to continued bracket creep year to year.

Federal workers are being asked to accept a COLA freeze for fiscal 1984. Many private sector workers are renegotiating their labor contracts to strengthen their competitiveness and preserve their jobs.

They are also facing higher payroll taxes to help preserve the social security system. This is particularly true of self-employed small businessmen, who will pay more on their own salaries and as employers of others.

It would unfairly compound their difficulties if the third year were repealed, and recompound them every year thereafter if indexing is removed and income tax rates are made to rise continually.

The only beneficiaries of repeal of the third year and indexing would be here in Washington. As for the country at large, substantial job loss would result as American workers were made less competitive by a higher tax burden, and as savers withdrew from the market as rising tax rates lowered the return on their savings.

SEVERAL TAX INITIATIVES IN BUDGET

While no major near-term tax increases will be proposed, there are several tax initiatives in the budget. These include: three new proposals designed to help restrain health costs, encourage family savings for higher education, and provide special incentives to hire the long-term unemployed; three proposals we are resubmitting to provide tuition tax credits, establish enterprise zones, and aid the Caribbean Basin; and tax initiatives recommended by the Social Security Commission to insure the solvency of the social security system.

CONTINGENCY TAX PLAN

In addition, the President has proposed a contingency tax plan designed to raise revenues of about 1 percent of GNP in the event that, after Congress has adopted the spending reduction proposals, there is insufficient economic growth to reduce the deficit below 2.5 percent of gross national product.

The contingency tax plan would not go into effect on October 1, 1985, unless the economy is growing on July 1, 1985.

The final chart, which is chart 6 in the submitted testimony, shows the effect on the deficit that the contingency tax would have if it were implemented.

It also shows how the budget picture would be altered by the stronger expansion that some private forecasters are expecting.

The deficit path under high growth reflects the assumption that real gross national product increases 1⅓ percentage points faster than in the official forecast, starting with fiscal 1983.

Such growth, by the way, would be in line with the performance from the end of 1960 to late 1966.

The contingency tax plan would contain two elements, each raising about half the revenues that may be required. One element would be a limited temporary surcharge of 5 percent on individuals and corporations. The other element would be a temporary excise tax on domestically produced and imported oil designed to raise revenues of about $5 a barrel.

The contingency tax alternative shown in the budget raises $146 billion over the 36-month period beginning October 1, 1985.

If these budget saving proposals are enacted, we will reduce the projected deficits by a total of $580 billion over the next 5 years, or by $2,400 for every man, woman, and child in the United States.

CLOSE U.S. TIES WITH OTHER INDUSTRIALIZED NATIONS

Finally, in setting the proper course of policy for the eighties, we must work closely with other industrialized and newly industrializing nations of the world.

The members of the International Monetary Fund (IMF) have agreed in principle on measures to strengthen the ability of the IMF to deal with the current strains in the international financial system. These measures include an increase in IMF quotas of 47½ percent, from about 61 billion SDR's, or $67 billion, to 90 billion SDR's, or $99 billion, and an expansion of the General Arrangements to Borrow (GAB) from about 6.5 billion SDR's, or $7 billion, to 17 billion SDR's, or $19 billion.

The proposed increase in the U.S. quota would be about 5.3 billion SDR's to a new level of 17.9 billion SDR's, and our shareof the expanded GAB would be 4.25 billion SDR's.

U.S. INCREASED PARTICIPATION IN IMF

The participation of the United States in the increase in IMF resources is an essential complement to domestic measures for an economic recovery and represents a valuable investment in the defense of the economic interests of the American farmer, laborer, businessman, and consumer. Legislation providing for budget authorization and appropriation for the U.S. share of the increase in IMF resources will be submitted in the near future.

An increase in the U.S. funding for the IMF, about $8½ billion, does not involve net budget outlays or affect the budget deficit, because any transfers by the United States to the IFM are simultaneously offset by an increase in our international monetary reserve assets. So I urge prompt approval by the Congress.

I believe, Mr. Chairman, we have fashioned a reasonable approach to the deficit problem that should be credible to the financial markets, the Congress and the American people. We are renewing our commitment to limiting the tax burden, to reducing the growth of Federal spending, to eliminating excessive regulations, and to a moderate and steady monetary policy.

At the same time, we have significant new initiatives in the budget to fight the most pressing problem in America today, unemployment, and we are working with the Congress on an additional jobs program. We are confident that the deficit reduction program contained in this realistic budget is the right program for the economy at this critical juncture.

The most important signals we can send the economy are spending restraint, deficit restraint, and a commitment to noninflationary economic growth throughout the decade.

This is the program we have devised. Together with the Congress we can make it work.

Thank you, Mr. Chairman.

PREPARED STATEMENT

Chairman HATFIELD. Thank you, Mr. Secretary. We will place your prepared statement in the record at this point, after which we will proceed with questions.

[The statement follows:]

PREPARED STATEMENT OF HON. DONALD T. REGAN

SECRETARY OF THE TREASURY

Mr. Chairman and Members of the Committee:

It is a pleasure to meet with you today and to discuss the Administration's 1984 budget proposals. The development of a sound fiscal policy was one of the central objectives of the Reagan Administration when it came into office two years ago. For too long a time Americans had watched the share of GNP accounted for by Federal spending and taxes move upward. As the government siphoned off resources from the private sector and the money supply expanded, economic activity stagnated and inflation soared.

In February 1981 the Administration put before Congress a four point plan to revitalize the economy. Our program included spending restraint, tax reductions, regulatory reform, and support of the Federal Reserve's efforts to attain gradual, steady reduction in the rate of monetary growth.

The transition to a noninflationary environment has been somewhat more difficult than anticipated. We have seen two years of serious economic recession as a result of the inflation/tax spiral and monetary volatility.

However, the recession now appears to be over. The unemployment rate declined in January for the first time since July 1981. There has been clear progress on inflation, and consumer price growth has dropped dramatically from 12.4 percent in 1980 to 3.9 percent in 1982. The producer price index fell by 1.0 percent in January -- the sharpest drop in the history of the index. Interest rates, which had been driven to record levels by inflation, are down from peak levels of 21-1/2 percent on the prime in December 1980 to 11 percent currently, and the stock market last year made new highs. Indicators such as housing, inventories, and real income show the economy is poised for recovery. Despite these favorable developments, further reductions in unemployment are still necessary.

The task now is to encourage the renewal of economic growth to reduce unemployment and provide productive job opportunities in the private sector. In so doing we must not repeat the errors of the past and return to an inflationary economy.

The current domestic situation is complicated by the existence of large Federal budget deficits and the threat of even larger ones in years to come. These budget deficits will have to be reduced, since their persistence would inevitably lead to very adverse consequences for the U.S. economy and its financial markets.

Many of the economic difficulties we face at home are also faced by countries abroad. The entire international economy is experiencing a severe slowdown, complicated by the special debt-servicing problems of a number of countries. My prepared statement today deals primarily with the U.S.

domestic economy, but it is obvious that the domestic and international situations are closely linked. The clear need in both cases is to encourage expansion rather than undergo further contraction.

It is important to recognize that current difficulties are the culmination of a long period of deteriorating economic performance in this country. The U.S. economy was in deep trouble long before the current recession began. It follows that our policies must aim at lasting long-run solutions. There are no quick cures.

Inflation has led to a roughly parallel rise in key interest rates. As shown in Chart I on interest rates and inflation, the 3-month Treasury bill rate followed the rate of inflation very closely over most of the period from the early 1960's to present. Thus, inflation appears to have been a major factor in the increase in the bill rate during that time.

Rising rates of inflation after the mid-1960's did not lead to more rapid economic growth for any sustained period of time. Quite the contrary. Inflation and its inevitable consequence of higher interest rates finally choked off real growth altogether.

Approach of the Reagan Administration

The Administration's primary economic goal upon coming to office was a fundamental restructuring of the economy, including:

- bringing inflation under control;
- shifting the composition of activity away from government spending toward more productive endeavors in the private sector;
- providing an environment which would reward innovation, work effort, saving and investment, and in which free-market forces could operate effectively.

Over the past two years we have seen evidence that the Administration's program is working. The fundamental elements of recovery are now largely in place. Inflation has been brought under control. Interest rates are coming down, as shown in Chart II. Real wage growth is being restored. In addition, there have been other improvements -- notably in productivity growth and saving behavior -- which mark a shift away from the problems that contributed to sluggish economic performance in recent years.

Within this framework of very significant achievements, there remains the fact that the economy has been in recession and unemployment is still high. The civilian unemployment rate of 10.4 percent in January is, of course, a matter of great concern. The President has indicated in his State of the Union Message that he will be submitting special legislation to help deal with the problem.

The Current State of the Economy

The economy now stands poised for recovery. In fact, the recovery appears to be underway at this moment. It has been

much longer in coming than we, or for that matter nearly all forecasters, had expected.

The delay occurred primarily because of the persistence of high interest rates and because of developments in the international sphere. On the international front, the economies of our leading trading partners continued to weaken. Weakness among all the industrialized nations was self-reinforcing. Furthermore, the financial difficulties of some of the newly industrializing nations had adverse impacts on economic activity here. These forces, combined with a general hesitancy on the part of the consumer, led to another round of inventory cutting in the second half of 1982 and delayed the expected turnaround of the economy.

Signals of an Economic Upturn

There are now clear signals that the economy has turned around and that the recession is now behind us. To summarize these signals:

- The unemployment rate for the civilian labor force fell sharply from 10.8 percent in December to 10.4 percent in January.
- The index of leading indicators has risen for eight out of the last nine months.
- Housing is in the midst of a rapid recovery.
- Business trimmed inventories sharply in the final quarter of last year. Historically, a cleanout of inventories typically has been followed by a shift back to higher rates of production.
- Retail sales have begun to firm.
- Total industrial production stabilized in December and evidence available on employment and workhours in January indicates that production will almost certainly rise for the month.

The Typical Recovery

We would all hope for a vigorous recovery, not unlike those which occurred in the past. The typical postwar recovery path is shown in Chart III. Excluded from it are two atypical recoveries -- the first of which included the Korean War buildup and the second which got underway late in 1980 but was short-lived. The five recoveries contained in the average line in the chart were remarkably similar. Gains over the first eight quarters from the real GNP trough were within an extremely narrow range of 5 to 6 percent at an annual rate.

The contributions of GNP components to real growth during the typical recovery are shown in Chart IV. As it indicates, much of the initial thrust for expansion comes from:

- a resurgence in homebuilding activity, such as currently is underway;
- a swing in inventory investment from decumulation in the later stages of recession to accumulation; and

- a major contribution from consumer spending, with purchases of consumer durables registering particularly large increases.

By contrast, Federal spending normally declines as a share of GNP during recovery, and is not necessary for promoting expansion.

The Outlook for the Economy

A vigorous recovery of the type outlined would be most welcome. It would certainly help ease the Nation's budgetary problems. However, we recognize that the serious problems still confronting us may well hold growth during the next year or two below the typical recovery pattern.

- Our overall trade balance is likely to register further marked deterioration in the coming year.

- Real interest rates may persist at high levels, though remaining below those prevailing a year ago.

- The economy is in the process of undergoing marked structural change. Some of our industries may not quickly regain the vitality they experienced in the 1950's and 1960's. The shift of resources to emerging industries will take time.

- Most fundamentally, we are not yet fully out of the inflationary woods, and we cannot afford to direct monetary and fiscal policy toward excessively rapid economic expansion.

For these reasons, the Administration's official forecast contains a fairly conservative estimate of real growth at a 3.1 percent rate during the four quarters of 1983, rather than the typical recovery growth rate of about twice that much. The favorable results in the January employment survey indicate that recovery could well be stronger than forecasted, which we would certainly welcome. Growth is expected to average in the 4 percent range in 1984 and the years beyond.

The Congressional Budget Office forecast for 1983 and 1984 is roughly similar to the Administration's. It also shows moderate growth, well below the average cyclical recovery. Both forecasts are cautious and note uncertainty about the recovery.

However, the CBO is somewhat more optimistic about real GNP growth, unemployment, inflation, and interest rates in 1983 and 1984. The differences are modest in the first year and narrow in the second. According to CBO:

- Real GNP is expected to grow by 4 percent over the four quarters of 1983 and 4.7 percent during 1984 (compared to Administration estimates of 3.1 percent and 4.0 percent).

- Unemployment continues at very high levels, declining only gradually during the recovery, with average unemployment rates of 10.6 and 9.8 percent for the civilian labor force in calendar years 1983 and 1984. The Administration estimates 10.7 percent and 9.9 percent, respectively.

- The GNP deflator rises 4.7 percent in 1983, according to CBO estimates, and 4.6 percent in 1984 (compared to Administration estimates of 5.6 percent and 5.0 percent, respectively).

On balance, the CBO forecast shows somewhat stronger growth from 1983 through 1986, although somewhat lower growth in the following three years.

Policies for the Recovery

In setting policy for the remainder of the 1980's, we must recognize what we must not do. We no longer have the freedom of action to revert back to the overly stimulative monetary and fiscal policies pursued at times in the past, for these would surely lead to a resurgence of inflationary pressures and a new round of rising interest rates. Further, we must not reverse the fundamental tax restructuring put in place in 1981, for this was designed to provide the noninflationary incentives without which the private sector would continue to wither.

Policies for a Changing Economic Structure

For years private sector initiative and dynamic market forces have been stifled by unnecessary Federal regulation. It is important that we carry through with policies of reducing the regulatory burden on private industry. Noteworthy successes have been achieved in this area, particularly in the deregulation of the financial system. For the first time in the postwar period, small investors can count on being able to obtain market rates of return on their savings from banks and thrift institutions.

Further, we recognize that our economy and those of the other industrialized nations are undergoing a period of restructuring. This is an era of rapid technological change, and comparative advantage in the production of many goods and services is shifting from the already developed to the newly developing nations. Those nations which expend all their energies shoring up declining industries and resisting change will find themselves with industrial bases that are obsolete and with declining relative standards of living. Their more foresighted and innovative neighbors will be moving forward and capturing newly opening markets.

Government can ease the painful process of structural change within the economy. We have significant new initiatives in the budget to fight unemployment and we are working with the Congress on additional jobs programs.

Finally, in setting the proper course of policy for the 1980's, we must work closely with the other industrialized and newly industrializing nations of the world. The members of the International Monetary Fund (IMF) have agreed in principle on measures to strengthen the ability of the IMF to deal with current strains in the international financial system. These measures include an increase in IMF quotas of 47.5 percent, from SDR 61 billion (the equivalent of about $67 billion) to SDR 90 billion (about $99 billion), and an expansion of the General Arrangements to Borrow (GAB) from about SDR 6.5 billion ($7 billion) to SDR 17 billion (about $19 billion). The proposed increase in the U.S. quota would be about SDR 5.3 billion, to a new level of SDR 17.9 billion, and our share of the expanded GAB would be SDR 4.25 billion.

The participation of the United States in the increase in IMF resources is an essential complement to domestic measures for economic recovery and represents a valuable investment in defense of the economic interests of the American farmer, laborer, businessman, and consumer. Legislation providing for budget authorization and appropriation for the U.S. share of the increase in IMF resources will be submitted in the near future. The increase in U.S. funding for the IMF, SDR 7.7 billion ($8.5 billion), does not involve net budget outlays or affect the budget deficit because any transfers by the United States to the IMF are simultaneously offset by an increase in our international monetary reserve assets. I urge prompt approval by the Congress.

Monetary Policy

In addition to policies aimed at facilitating structural changes within the economy, we must maintain steady monetary and fiscal policies directed at reinvigorating economic activity. Steady, predictable money supply growth at a noninflationary pace has been, and continues to be, one of the major goals of the Administration's economic program. The Federal Reserve's efforts to achieve that goal have been complicated by a number of factors, such as far-reaching institutional changes in the banking and thrift industries. Nevertheless, the Fed has generally been successful, albeit in a somewhat erratic fashion.

Monetary policy faced a difficult and uncertain situation during much of the last year. Rapid institutional change in the form of new money market instruments blurred the boundaries between the various aggregates and made the achievement of any target rates of growth unusually difficult. There is also some indication that the recession may have led to an increased demand for liquidity and precautionary balances. In 1982, growth in monetary velocity -- the rate at which money is used -- turned negative for the first time in nearly three decades. Under the unusual economic and institutional circumstances of 1982, some temporary offset in the form of above-target rates of monetary growth was probably desirable.

The Federal Reserve's efforts to slow money growth have been accompanied by some volatile short-run swings. Growth in M1 was actually negative on a 13-week basis by mid-summer of last year, and then soared to the double-digit range by the end of the year. This recent acceleration has caused some observers to conclude that the fight against inflationary money growth has been abandoned. That is not true. Both the Administration and the Federal Reserve remain committed to the long-run goal of providing money growth at a noninflationary pace consistent with a steady and sustainable expansion of economic activity.

Fiscal Policy

The objectives of our fiscal policy upon coming to office two years ago were two-fold. First, we believed and still believe it was imperative to correct the disincentives to economic performance that had been built into the tax structure over the years. These disincentives arose in large measure, not by design, but through the interaction of a high rate of inflation with a progressive tax system and historical cost accounting of depreciable assets. Second, it was equally imperative to reverse the seemingly inexorable growth of Federal spending, thereby freeing resources for use in the private sector. In moving to achieve these goals, we faced one major constraint, namely that our defense establishment had been allowed to deteriorate badly, so that our national survival mandated a stepped-up rate of defense spending.

The tax reforms that were put in place were designed primarily to restore an adequate rate of return for investment in plant and equipment and to put a halt to the steady ratcheting upward of marginal tax rates on labor and savings income. The investment incentives were necessary to bring long-depressed rates of business capital investment and productivity growth back up to acceptable standards. For individuals, the tax cuts were needed to protect incentives and purchasing power, and to keep American labor competitive in world markets. For the average taxpayer, they will only result in an actual dollar tax cut in 1983, after allowance for the effects of bracket creep and higher social security taxes. And that 1983 cut and tax indexing will be needed to offset bracket creep and increases in social security taxes scheduled to take effect in the future. These measures will greatly improve the competitive standing of American capital and labor in the world as economic recovery proceeds.

I want to discuss briefly the tax cut enacted in 1981 and address some of the misconceptions about the act, namely that the tax cut was much too large and as a result, it destroyed our revenue base and caused the budget deficits we are facing.

Rather than being too large, the tax cut enacted in 1981 just barely offsets rising tax burden on the economy.

Between fiscal 1981 and 1988, ERTA reduces taxes by $1,138 billion, a substantial amount. But a substantial tax cut is needed to offset the equally substantial tax increases facing the American taxpayers between fiscal 1981 and 1988.

- Last summer's tax bill raises taxes by $281 billion.
- The gasoline tax bill raises taxes by $21 billion.
- Inflation-induced bracket creep raises taxes by $489 billion.
- Previously-scheduled social security taxes raise taxes by $214 billion, and the proposed bipartisan social security rescue plan will raise $56 billion.

The total tax increases amount to $1,061 billion, leaving the taxpayers with net tax cut of only $77 billion between 1981 and 1988.

Rather than destroying the tax base, as many have suggested, the 1981 tax cut merely "returns revenues as a percentage of GNP to approximately the levels that prevailed in the 1960's and 1970's," according to the Congressional Budget Office's recent report on the budget.

Under the Administration budget, taxes as a percent of GNP for fiscal years 1983 to 1986 will average 19.2 percent. This is a level slightly higher than the 18.6 percent average for the 1960's and the 18.9 percent average for the 1970's. It is low only in comparison to the high tax level of the previous Administration, which reached 20.9 percent in fiscal 1981.

And as CBO points out, the tax burden during the 1980's "would have moved well above the all-time record of 21.9 percent of GNP reached in 1944" without the tax cuts.

CBO also reports that due to the tax cut individual income taxes as a percent of taxable personal income will average 12.3 percent for the 1984 to 1988 period. This is a level below the 14.3 percent rate in 1981, the highest level in history, but close to the 12.2 percent average rate for the 1970's.

Without the tax cut, CBO notes, the tax rate would have risen to an "unprecedented" 18.4 percent by 1988. And without indexing, the tax rate would rise to the near-record level of almost 14 percent by 1988.

Repeal of the remainder of the tax cut would strike disproportionately at lower income workers and retirees. Repeal of the third year would cause a 13.9 percent jump in tax liability for those with less than $10,000 in adjusted gross income, a 12 percent jump for those between $20,000 and $30,000, and only a 2.7 percent jump for those with $200,000 and over.

The unfairness of repeal is even more pronounced with indexing. Assuming 4.5 percent inflation, repealing indexing would produce a 9.4 percent jump in tax liability for those with less than $10,000 in adjusted gross income, a 3.2 percent jump for those between $20,000 and $30,000, and a one-half percent jump for those with $200,000 and over. Even worse, these latter increases from repeal of indexing would be repeated each year as long as inflation continues.

Indexing is of relatively greatest importance to lower bracket taxpayers. First, the lower brackets are narrowest in percentage terms, and inflation causes income to rise through the brackets fastest at the bottom. Second, for those in the lower brackets, personal exemptions and the zero bracket are large relative to total income. Indexing keeps these exemptions from losing real value, and keeps inflation from pushing those too poor to owe tax onto the tax rolls. Third, upper income taxpayers may already be in the top tax bracket, with no higher bracket into which to be pushed.

In addition to the significance for individuals of the third year cut and indexing, both of these measures are of critical importance for small businesses. Small businesses tend to be labor intensive, and the Administration's program of reducing marginal tax rates and indexing will help limit wage pressures, enabling American labor to maintain competitiveness with workers overseas. In addition, because over 85 percent of small businesses pay only personal income tax, the Administration's tax program will help directly to safeguard the value of their earnings.

There have been suggestions that proposals to delay retirement COLAs or pay increases should be accompanied by repeal of the third year or indexing to increase fairness, as if these proposals somehow impact different groups. In fact, this would impose an unfair double burden on workers, savers, and pensioners of all income levels who are simultaneously income recipients and taxpayers.

We are asking social security recipients to accept a 6-month delay in their cost-of-living increase, and the taxation of a portion of benefits for upper income retirees to help save the Social Security System. It would be unfair to raise tax rates on their other pension or interest income by repealing the third year, or to subject their fixed retirement incomes to continued bracket creep year after year.

Federal workers are being asked to accept a COLA freeze in FY 1984. Many private sector workers are re-negotiating their

labor contracts to strengthen their competitiveness and preserve their jobs. They are also facing higher payroll taxes to help preserve the Social Security System. This is particularly true of self-employed small businessmen, who will pay more on their own salaries and as employers of others. It would unfairly compound their difficulties if the third year were repealed, and recompound them every year thereafter if indexing is removed and income tax rates are made to rise continually.

The only beneficiaries of repeal of the third year and indexing would be here in Washington. As for the country at large, substantial job loss would result as American workers were made less competitive by a higher tax burden, and as savers withdrew from the market as rising tax rates lowered the return on their savings.

We were relatively successful in working with the Congress to achieve our goals of tax reform, but we were less successful in the area of outlay control. A major portion of the savings we had proposed in our original budget did not receive favorable action. This, along with much weaker economic activity than expected, has left us facing the prospect of large deficits even as the economy recovers.

The proposals in the FY-1984 Budget are directed at the crucial task of restoring noninflationary economic growth. This requires the preservation of the investment and work incentives provided by the tax reforms of 1981 and a reduction in the high deficits and interest rates which lie ahead unless corrective action is taken to bring government outlays under control.

The tax reforms already enacted will enable us to make good progress in rebuilding and modernizing America's plant and equipment as the recovery progresses. Incentives are in place to encourage saving and investment and to lower the cost of new machinery and structures. Taxes on American labor are coming down. These reforms will lead to a more productive, more competitive United States. The capital formation program will be financed by higher levels of personal saving, more generous capital consumption allowances, and higher retained earnings as profits recover from the current slump. These elements, plus state and local budget surpluses, form the Nation's savings pool.

Spending reduction will contribute to the recovery, and the recovery will contribute to deficit reduction. The deficit will fall as the economy advances, particularly if the recovery is a vigorous one. A strong recovery with 1-1/3 percent more real growth per year than in our forecast would bring the budget to near balance by 1988, provided we also curb the growth of Federal outlays.

However, if we fail to bring spending under control and if recovery is slow, we will face a deficit problem which is larger and longer-lasting than we can afford. In such case, the deficit could run in the range of 6 to 7 percent of GNP each year through 1988. Our tax reforms were designed to raise the private savings share, but still we would face the possibility of draining off a large part of the pool of savings, leaving less available for new capital formation. Interest rates could remain high, and the recovery could stall.

This Administration is determined that deficits of such magnitudes will not come to pass. We came to office with a program of boosting the rate of capital investment in order to place the economy on a faster growth track, and we will not

allow ourselves to be diverted from that goal. We will take whatever measures are necessary to narrow the deficit to acceptable levels.

- Preferably, all of the necessary narrowing of the deficit would come from the outlay side. Total Federal spending represents the amount of resources absorbed by the government at the expense of the private sector. This spending can be financed by both taxes and borrowing, which in either case amounts to a drain on private resources. Only through spending reduction will the credit market find itself in a more favorable position.

- In the event that the combination of economic growth and outlay reductions is not sufficient to narrow the deficit to acceptable levels in the outyears, we are prepared to request additional revenue raising measures in those years. If the Congress chooses not to reduce spending, as we wish, then it is preferable to have the full cost of federal spending programs explicitly identified for the taxpayers who bear the burden of financing government. If additional revenues are needed, this Administration will do its best to structure the tax code in a way that minimizes disincentives for productive effort.

Our Budget Proposals

Spending reduction is crucial. Unfortunately, it has been difficult to achieve because of the built-in momentum of Federal spending programs. Consequently, we are proposing strong medicine. None of us will find it agreeable, but it is critical to the restoration of vitality to our economy. There must be assurance that all will share in spending restraint, just as all of us will share in the benefits of a revitalized recovery. We, like a great many other nations in the world, have tried to live beyond our means. Now we must bring our spending into line with our productive capacity and strengthen the private sector which produces our national wealth.

The deficit reduction program that we propose contains four basic elements.

- The first is a freeze on 1984 outlays to the extent possible. Total outlays should be frozen in real terms in 1984. The 6-month freeze on COLAs, as recommended by the Social Security Commission, is to be extended to other indexed programs. There will be a 1-year freeze on pay and retirement of Federal workers, both civilian and military. Many workers in the private sector have accepted freezes in their pay. Federal workers can also make a sacrifice, which hopefully will serve as an example for sectors of the economy which have not yet recognized the need for moderation in wage demands. As a final item of freeze, outlays for a broad range of nonentitlement programs will be held at 1983 levels.

- The second element of our budgetary program contains measures to control the so-called "uncontrollables." Laws have been so written that Federal payments are automatic to all those declared eligible. We plan a careful review of all such programs, taking special care to protect those truly in need.

- The third element is a cutback of $55 billion in defense outlays from original plans.

- Fourth is a set of proposals involving the revenue side of the budget, described below.

We are projecting receipts for the current year (fiscal year 1983) of $597.5 billion. For fiscal year 1984 we expect receipts to be $659.7 billion. The 1983 figure represents a decline of $20.3 billion from the fiscal year 1982 total of $617.8 billion. This decline, and indeed the absence of an increase in receipts in the range of $50-70 billion, is due primarily to the recession. As I have already explained, our economic projections throughout the remainder of the recovery period are cautious. If real GNP grows at a faster rate than we have projected, then receipts for the current fiscal year, as well as for subsequent years, will be somewhat higher than we are now projecting.

In 1984, as the recovery is well underway, receipts are expected to rise to $659.7 billion, an increase over 1983 of $62.2 billion, representing an annual growth of 10.4 percent. This will occur as profit margins recover and other income shares continue to grow.

For the other years in our forecast period (1985-1988) we project an average annual growth rate of receipts about 10 percent without contingency taxes (and 11 percent per year including contingency taxes), with receipts reaching the $1 trillion mark for the first time in fiscal year 1988. All of these projections assume the legislative proposals included in the President's Fiscal Year 1984 Budget. Receipts under existing legislation will also grow, but at a somewhat lower 9-1/2 percent annual average rate.

The estimates of receipts made by the Congressional Budget Office reflect the higher real economic growth forecast by CBO in 1983 through 1985 and the somewhat lower growth thereafter. Thus far, CBO has published only baseline numbers, analogous to current services estimates without policy changes. As compared to the Administration current services projections, CBO estimates receipts to grow more quickly during the first 3 years of the period and more slowly during the latter three years, because of differences in projected rates of real economic growth. CBO's outlay estimates run below the Administration's throughout the period, mainly because of the difference in the basis for estimating defense spending. Therefore, on balance, CBO projects smaller baseline deficits than the Administration does on a current services basis.

It is noteworthy that under Administration proposals individual income tax receipts will continue to rise over the 1985-1988 period, but only as <u>real</u> income rises. Beginning in 1985, we will no longer collect hidden taxes in the form of bracket creep caused by inflation. Without the indexation provision of ERTA, individuals would pay $6 billion more in taxes during fiscal year 1985 alone, and about $100 billion more during the entire forecast period -- 1985 through 1988.

There has been a gradual upward trend in unified budget receipts as a percent of GNP, shown in the top line of Chart V. As shown in the bottom line of the chart, a major shift in the composition of receipts has been the rising share of social insurance and other payroll taxes to fund social security and other retirement benefits.

There is no proposed omnibus tax bill in the President's budget message. However, there are several separate tax items. Proposed tax legislation in the President's budget can be conveniently grouped under three broad headings: Proposals that improve the income security of Americans, proposals that will improve our ability to produce future output, and, as an insurance policy, a contingency or standby tax, which is intended as a clear signal that we will not permit spending to increase in the outyears unless we pay for it up front.

In the first category, our principal recommendation is for adoption of the bipartisan social security proposals. These proposals, which will increase receipts to the social security funds by $9.8 billion in fiscal year 1984, $11.6 billion in 1985, and $10.6 billion in 1986, are necessary to insure the solvency and security of these trust funds.

The second category, proposals to improve the utilization of our human resources, includes the tuition tax credit, the exclusion of earnings on savings for higher education, the jobs tax credit for hiring the long-term unemployed, and the enterprise zone tax incentives. These will all improve our production capacity, either through increased investments in education or, more directly, by getting our currently underutilized force of experienced workers back to work. As a group, these proposals will reduce taxes $0.5 billion in 1984, $1.2 billion in 1985, and $1.7 billion in 1986.

Finally, the President has proposed a contingency tax plan designed to raise revenues of about 1 percent of GNP in the event that, after Congress has adopted the spending reduction proposals, there is insufficient economic growth to reduce the deficit below 2-1/2 percent of GNP. The contingency tax plan would not go into effect on October 1, 1985, unless the economy is growing on July 1, 1985. The contingency tax plan is an insurance program. It is important to have a plan in place so that the country and the world know that we will not tolerate a string of deficits that would exceed 2-1/2 percent of GNP. Chart VI shows the effect on the deficit that the contingency tax would have if it were implemented. It also shows how the budget picture would be altered by stronger expansion such as some private forecasters expect. The deficit path under high growth reflects the assumption that real GNP increases 1-1/3 percentage points faster than in the official forecast path, starting with FY-1983. Such growth would be in line with the performance from the end of 1960 to late 1966.

The contingency tax plan would contain two elements, each raising about half of the revenues that may be required. One element would be a temporary surcharge of 5 percent on individuals and corporations. The other element would be a temporary excise tax on domestically produced and imported oil designed to raise revenues of about $5 per barrel. The contingency tax alternative shown in the budget raises $146 billion over the 36-month period beginning October 1, 1985. The specific contingency tax plan we will be sending to Congress for adoption this year will be designed to raise revenues of about $130-150 billion over a temporary period of up to 36 months.

If these budget saving proposals are enacted, we will reduce the projected deficits by a total of $580 billion over the next five years, or by $2,400 for every man, woman, and child in the United States. The deficit as a share of GNP will be down to about 2-1/2 percent in 1988 from the 6-1/2 percent we expect this year. Total outlays will grow by only 7 percent per year in nominal terms over the next five years, compared with a bloated 13 percent between 1977 and 1981.

In addition, as part of our overall program, over the next year we will be taking a careful look at the entire structure of our tax system. We will be searching for ways to simplify the tax code and make it fairer while at the same time promoting economic growth by enhancing incentives for work effort, saving, and investment. This is the true road for putting people back to work and bringing the budget into balance.

We are confident that the deficit reduction program contained in this realistic budget is the right program for the economy at this critical juncture. The most important signals we can send the economy are spending restraint, deficit restraint, and a commitment to non-inflationary economic growth throughout the decade. This is the program we have devised. Together with the Congress, we can make it work.

Chart I

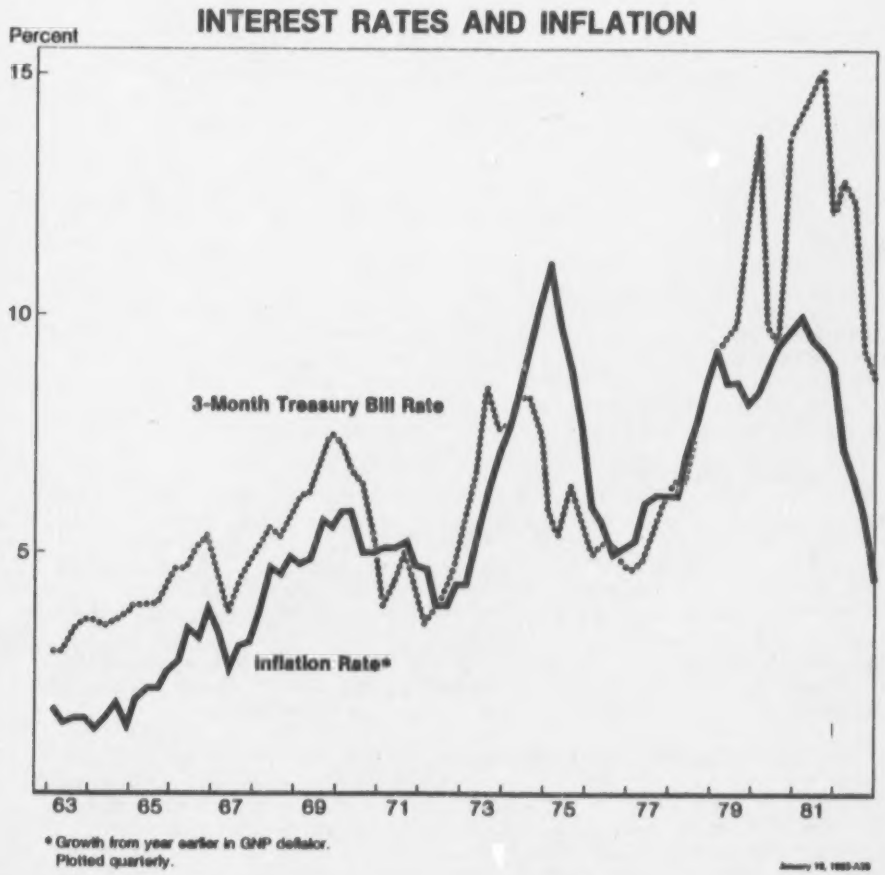
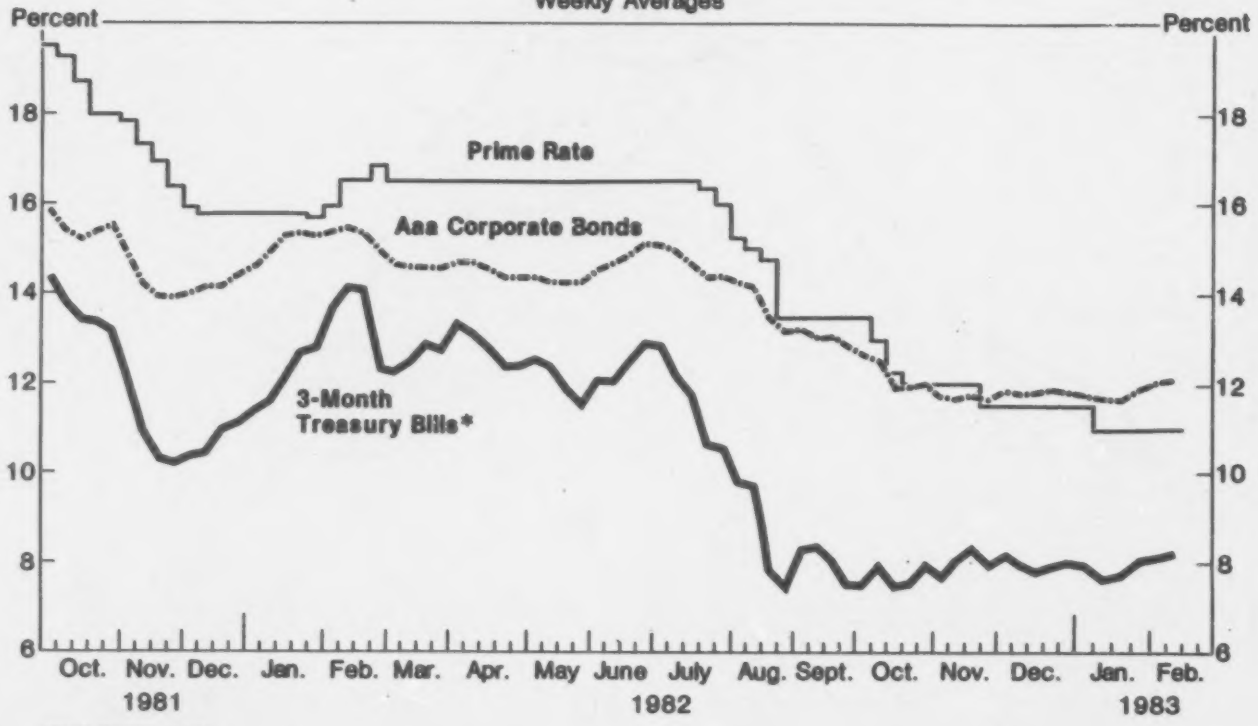


Chart II

INTEREST RATES

Weekly Averages

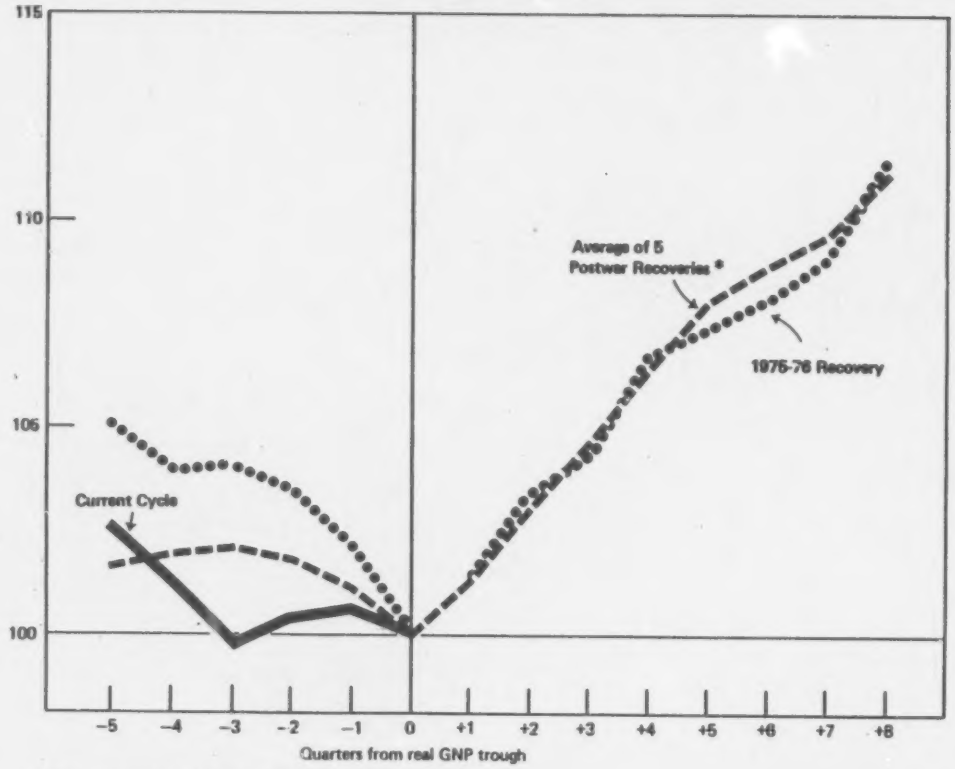


*Bank discount basis

Chart III

THE PATH OF POSTWAR ECONOMIC RECOVERIES

Real GNP trough = 100

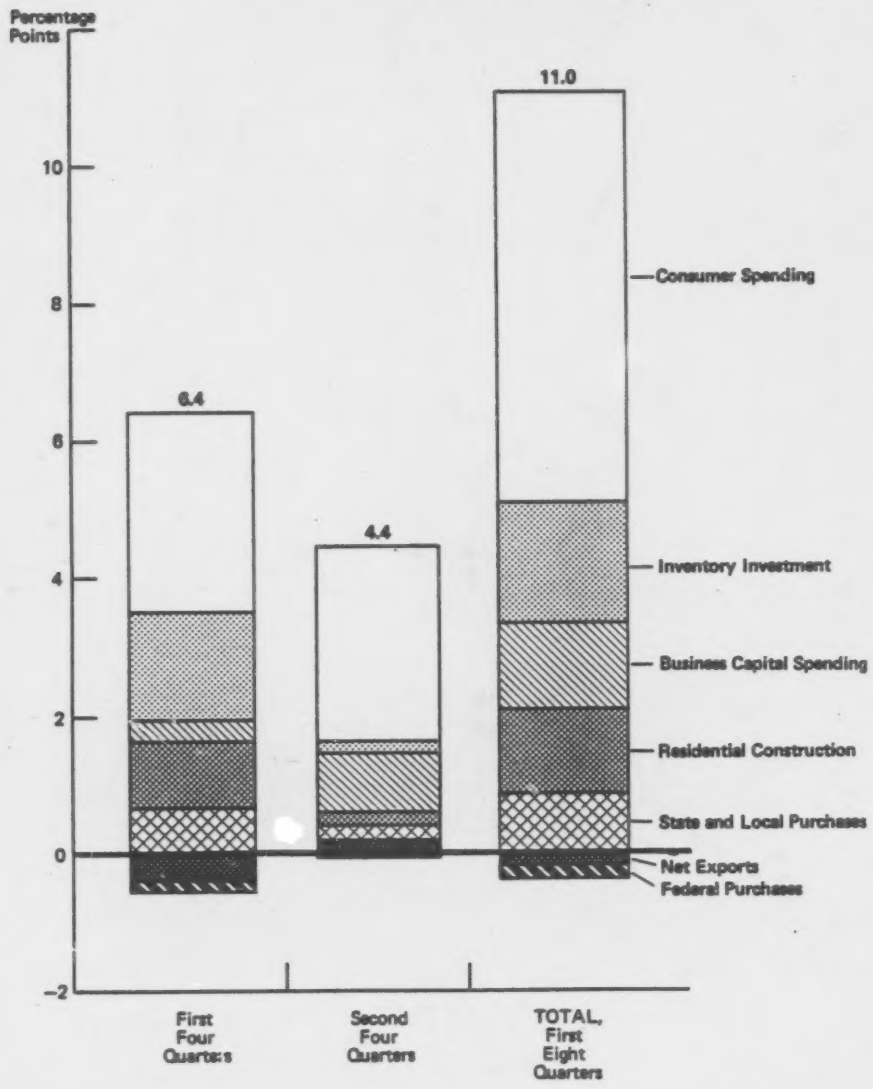


* Postwar recoveries excluding the Korean War period and the short-lived 1980-81 recovery.

January 26, 1983-A210

Chart IV

CONTRIBUTIONS TO A TYPICAL RECOVERY* BY REAL GNP COMPONENT



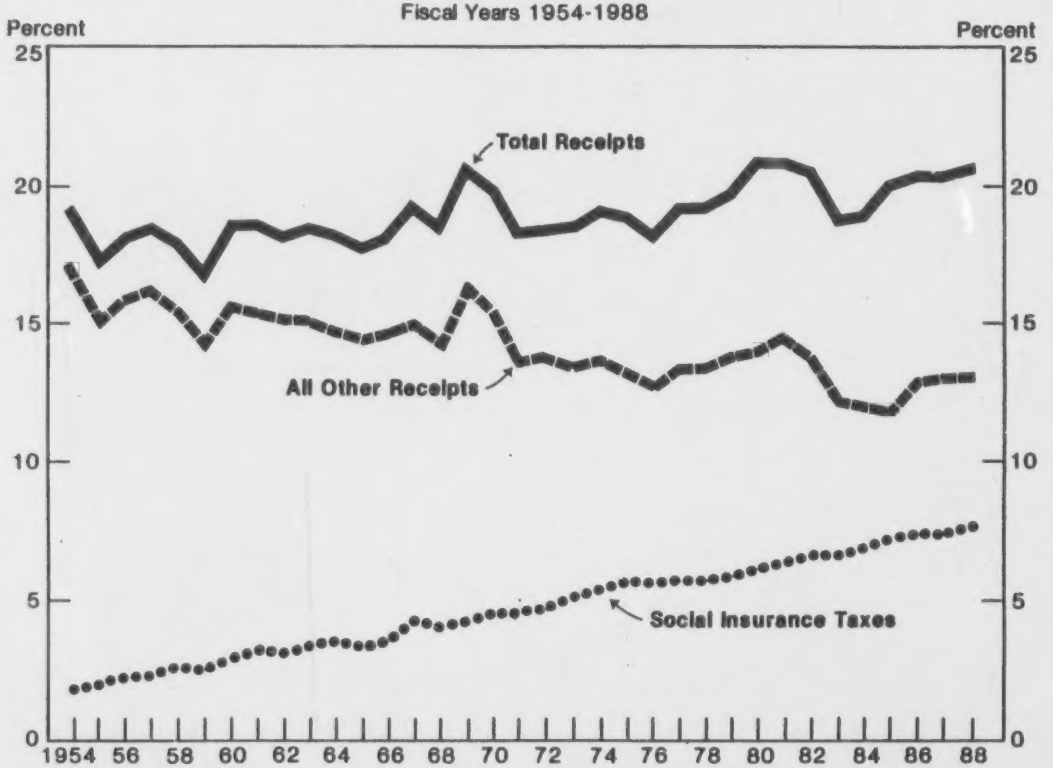
* Average of postwar recoveries, excluding the Korean War period and the short-lived 1980-81 recovery.

January 21, 1983-A213

Chart V

UNIFIED BUDGET RECEIPTS AS A PERCENT OF GNP *

Fiscal Years 1954-1988

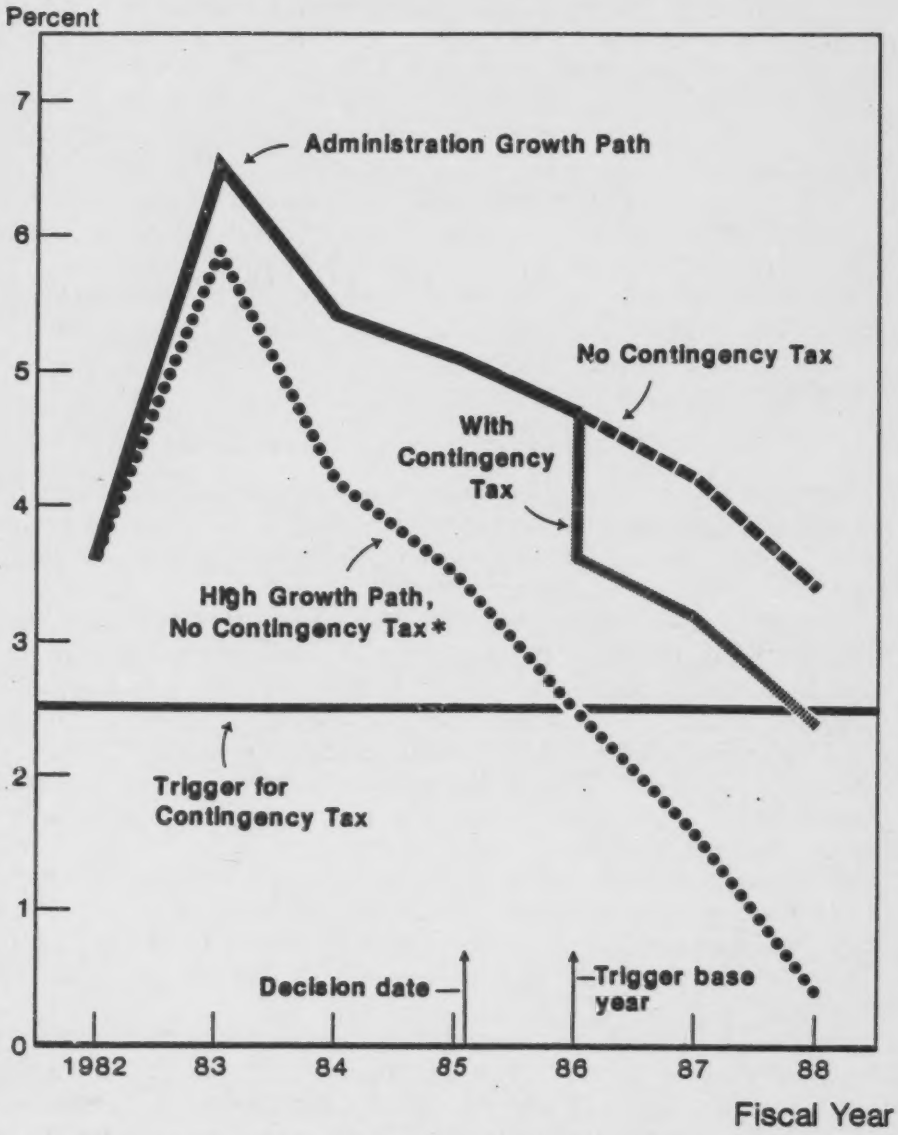


* Receipts include contingency taxes.

January 28, 1983-A216

Chart VI

THE DEFICIT AS A SHARE OF GNP



*Higher growth than the official path by 1-1/3 percentage point starting fiscal year 1983.

January 28, 1983-A214

FUTURE OUTLOOK ON ECONOMY

Chairman HATFIELD. Mr. Secretary, through the years the American economy has had a series of stops and starts. We have had, as you know, two recessions since 1980.

My question to you is, do you believe that a healthy and enduring recovery is attainable now or are we doomed to further short-term stops and starts as we have experienced in the last 10 or 20 years?

Secretary REGAN. Mr. Chairman, with a couple of provisos we can have a sustained recovery in this economy. The two provisos are: One, a monetary policy that gives us moderate growth in the money supply, not a stop and start type of operation in the money markets; and a fiscal policy that indicates that these deficits are going to be coming down, particularly in the out years, and will be, as a percent of our gross national product, something that we can handle. My own judgment of that is something under 2½, in the 2- to 2½-percent range.

I think if both of those things are attained, there is no reason why we cannot have a sustained recovery.

EFFECT OF DEVELOPING COUNTRIES LOAN DEFAULTS

Chairman HATFIELD. Mr. Secretary, if one of the developing countries defaults on loans to a major U.S. bank, even to the point of perhaps bringing the bank down, what effect, both real and psychological, would this have on our own recovery?

Secretary REGAN. Well, if that were to happen, there would be more than one bank involved, because most of these foreign nations have loans from many banks in the United States.

At that juncture, it is my belief that the Federal Reserve, cooperating with the Treasury Department, would make every effort to protect the banking system of the United States—for example, the Fed, by making available its discount window for large scale borrowing by the bank to tide it over, and other similar arrangements.

We would be working with the country itself to prevent the default in the first place, if at all achievable, because the nation that defaults finds itself in very bad straits for the next decade or two, certainly a course that very few political leaders would want to inflict on their country.

Accordingly, I think that these things can be managed, but I am not one who is trying to say that at this point we are out of the woods or that a default might not happen. But I think that we are alert to the situation. We are monitoring it very closely, and I would hope that we could prevent anything happening of the sort that you have described.

HIGH UNEMPLOYMENT FIGURES

Chairman HATFIELD. Mr. Secretary, the unemployment figures concern us all. I know they concern you. When you go back and look in a span of time, they have had an adverse trend now for many years. If you go back to the sixties, we had an average unemployment of 4.8 percent. Then in the first half of the seventies, it rose to a figure of 5.4 percent. The last half of the seventies, it rose further to 7 percent, and thus far in the eighties it has been an average of 8.1 percent.

That has been a trend long enough to factor out the recessionary periods.

A recovery from any recession brings improvement, but not all the way back to previous levels. Why? Do we face worse and worse statistics in the future, or is there reason to think we can turn this around?

Secretary REGAN. That is a very complicated subject, gentlemen. I cannot give a very short answer that is all-encompassing, but let me suggest a few things that I think may be happening.

First of all, we are gradually changing. We are in an era of transition from once being a manufacturing nation to where we will be in the nineties and, indeed, in the 21st century. At that time, we will be much more highly technically oriented. For example, right now, only about 20 percent of all civilian jobs are in the manufacturing sector. That is a much smaller percentage than 20 or 30 years ago.

Seventy percent of jobs now are in service producing industries, including the information processing industries.

As we go from technical obsolescence into these new industries, we are going to have to retrain current workers; we are going to have to train the new workers coming into the work force in a different manner than we have in the past. So I suspect that much has to be done in the educational field and the like.

COST OF LABOR

The other thing we have to watch, Mr. Chairman, is the cost of labor. At the current moment, it costs an employer about $1.70 to give a worker a $1 increase in take-home pay. It is so high because of payroll taxes and the added State and Federal income taxes that the employee must pay. This makes the average employer hesitate to take on additional workers. I know that robotics has become quite a buzz word at this point, but when you think it through, why are we getting into robotics? In order to get labor-saving devices is literally the reason. The more deeply we look into these things, the clearer it becomes that employment will be held down in those industries that can be automated.

Therefore, it is incumbent upon us to make certain that we do try to retrain workers and also restrain the amount of increases that we are imposing on the costs of labor. If I might come back to being a little preachy again, in reference to the tax cut and indexing, if we continually have workers being pushed into higher tax brackets, they are going to insist upon higher wages in order to offset that. That is a never-ending spiral that we could get into.

So I would suggest that education, keeping down costs, and keeping taxes down are three ways that we can avoid this ever-increasing unemployment rate that seems to ratchet up with each business cycle.

TREND TOWARD SERVICE, INFORMATION ECONOMY

Chairman HATFIELD. What are we doing in terms of guiding the transitional period from an industrial production economy to a service, information economy as it relates to labor, management, the educational institutions, and other such groups? Is this happening by chance, or is

there any effort being made to help ease this transition and pick up the gaps?

Secretary REGAN. I think that educators and political figures, as well as management and labor leaders, are all beginning to realize that change is upon us and we had better get with it. We can't fight the tide any longer. I don't wish to be too damning of the American educational system, but as one who was a former chairman of the trustees of a major university, I know that some of the students coming into the university were not as well trained in mathematics and science as their counterparts, let's say, in the fifties and sixties. This is a shame. I think it is incumbent upon parents and it is incumbent upon secondary school educators to insist that students do it the hard way, that is, that they take many years of math and science so they are prepared for the new types of jobs that are going to be available to them once they get to the labor force.

I think, also, that there are a lot of service jobs, Mr. Chairman, that have gone begging because people don't like to work with their hands any more. I think this is one of the crimes. You try to find a plumber or carpenter or a service repairman and you will come to understand the problem I am suggesting.

I think a lot more people can be trained for such types of work, and it can be shown that it is meaningful to work with your hands; that there are many people who could benefit by working as artisans.

I think also that the Government, in its educational grants and the like, should be insistent that education of the future work force be properly directed. That is one of the things that you will find when our proposals come up here.

In the new budget, the administration requests funds for grants to States for training at least 1 million people a year under the recently enacted Job Training Partnership Act. It will be primarily youth training; at least 40 percent will be for youth training in the types of skills outlined above.

CONFERENCE ON TRANSITION

Chairman HATFIELD. But Mr. Secretary, isn't this the time for a White House conference on transition, of a coordinating effort, an ad hoc action to bring these various components together that you have enumerated?

I don't sense that there is really any guidance coming forth, or interagency or interdisciplinary or interinstitutional kind of coordinating efforts.

Secretary REGAN. I think you will see that, Mr. Chairman, in the National Productivity Committee's recommendations which are to be the subject later this year of four regional conferences and then a general conference here in Washington in October. I think one of the things that they will be focusing on is how to get more productivity, and this involves retraining the current workers, unemployed workers, as well as new workers entering the labor force.

Chairman HATFIELD. I would not like to see us leave that to chance.

FURTHER REDUCTION IN INTEREST RATES

Mr. Secretary, one last question: Why haven't interest rates come down further after the lowering by the Federal Reserve of the discount rate? They seemed to respond initially, and then they leveled out, even though the Fed continued to ease that rate. Is it the deficit that we have that has caused interest rates to stop declining?

Secretary REGAN. It is a combination of factors, Mr. Chairman. I think there are three principal ones. First of all, there is a fear of what is happening currently in monetary policy. It's not understood why the Fed is allowing M–1, for example, to increase by double-digit rates, 12, 14, 15 percent. M–2 had a very unusual jump in January. We think we know the reason why it jumped 30 percent, annual rate, in 1 month.

This has rekindled fears that inflation will reemerge in the near future—as we get into the recovery period. In addition, there is no doubt that our Treasury financings have had an influence on keeping rates up. We are borrowing now at the rate of over $50 billion a quarter, which is unheard of. The third quarter of this fiscal year, which is normally a period in which there is quite a reflow into Treasury, we will borrow over $30 billion. That is the type of thing that requires that the marketplace get large amounts of money up.

In order to get that money up, they generally demand higher rates of interest. So these huge deficits plus the monetary fears are two of the things that keep rates up.

I think the third one, being very candid, is bank earnings. I think banks, faced with a lot of problem loans, both domestic and international, are doing their utmost to bring their earnings up. So I think the leveling out was caused by a combination of those three factors.

Chairman HATFIELD. What do you do about such banks?

Secretary REGAN. I won't be the Secretary of the Treasury that tries to talk interest rates down. That is one. Several of my predecessors tried that with no degree of success. I don't choose to emulate that path.

I think what we have to do is keep a sensible monetary policy, and I understand that Chairman Volcker will be talking about this in the Congress tomorrow.

At the same time, I think that while we worry about the deficits of 1983, we should worry more about the deficits of 1984, 1985, and 1986. If we can show that they are coming down and that the Congress is facing up to this problem and that the administration will cooperate with the Congress in trying to get these deficits down, that will be very reassuring to the markets.

Chairman HATFIELD. We will do our best, especially in the defense area, to help bring deficits down.

I have taken my 10 minutes. Senator Stennis?

FEDERAL DEBT

Senator STENNIS. Mr. Chairman, I am going to be brief, but I want the Secretary to help me answer a key question. I have been out among the people recently, and I am surprised at the number that have asked me questions around this fact: In spite of the good news that the whole

amount of the Federal debt has already passed $1 trillion and now it's right on up close to $1.3 trillion—and that is in just a relatively short time. You have been working hard, but a good deal of that increase is during your regime.

Of course, you couldn't stop it all of a sudden, but at that point they ask me what is the cause of that, and frankly, I don't know how to answer it. But your statement here points out that it has been holding down the taxes in the meantime holding down the taxes so these obligations, as I see it now, reflected in the increase of the national debt of $1 1/3 trillion rather than being reflected here in a method to get rid of that current deficit, and we increase the total Federal debt by having more increases.

Did I make the point clear? If you could help me answer that question and reduce it to commonsense. What is the commonsense answer to the point I raised?

Secretary REGAN. I think the commonsense answer, Mr. Chairman, is that in a period of recession and the like you need stimulus for the economy. One of the great ways to stimulate the economy is through fiscal means. That requires budget deficits. You can do this by increasing spending or cutting taxes.

It has always been my belief that allowing people to have their own money to spend is a lot better way to do it than to have the Federal Government take the money away from them and then try to rechannel it. I'm not one that believes that the Federal Government is so all-knowing that it can channel properly. I think that people left to their own devices, through a tax cut, will either save that money—savings can be used in the housing industry or other types of investment—or they will consume it, which means more spending.

I think that is exactly what we want today, a combination of more spending by consumers and more savings by individuals in order to have the savings available to those who will invest and put people back to work.

I think in the out years, as we go along, then you have to be cautious, because I think—well, you have had a lot more experience in the Federal Government than I—I think you realize that the more money we allow the Federal Government to have, the more money it will spend. I have never known of a Federal bureaucracy that will say that they don't want more money. So I think that that is what we are saying: You have to cut back on the amount available to the Federal Government. That is why we are for indexing and the like.

Our thought is that the proper way to get these deficits down in the future is by cutting spending, not raising taxes.

PROJECTED FEDERAL DEBT

Senator STENNIS. That is generally true, no doubt, and part of an answer, but at the same time, we are climbing all the time in this Federal debt. As I understand your calculations, this would continue on until 1988, perhaps, and on up into an even larger percent of the gross national product for those few years ahead.

It seems to me we ought to be trying to whittle away at both ends of this thing now: A reduction in expenditures and there is some way to increase the revenue income and at the same time, you will just be fighting the problem from two ends when now, we have turned one of them loose almost, as I see it, and it is running out the top.

That doesn't discredit you. I wanted to ask you something about your interest rates and all. I remember how you fought from the very beginning about that, and you have been disappointed over and over when we go up and come back down and so forth. Now you think your base is more stabilized, as I understand it, right?

Secretary REGAN. As far as interest rates are concerned, yes. I would think that if we maintain the sensible course that——

Senator STENNIS. Maintain what?

Secretary REGAN. A sensible course, that is, of not having too much in the way of stimulation, in spending, particularly in the out years, and if our monetary policy is for steady slow growth rather than a volatile policy of rapid growth and then no growth, then that steady growth, I think, will lead money markets to respond by reducing the rates.

PROBLEMS IN EDUCATION

Senator STENNIS. There is one thing I want to respond to: I have noticed that you mentioned the educational problems, and I'm no educator. You said you were once chairman, I believe, of the board of a major educational institution, but I tell you, from just a countryman's point of view, I have been knowing for some years that the boys and girls were just not being required to do their best and study hard, if I may use that term, on purely educational matters. Now these engineers tell me, and I use that group for those out front, you know.

One group of them was called on to take us to the Moon and in the military, many, many times they have been called on to get out front to provide the remedies. Now they are saying that they are feeling a great shortage of the right kind of talent, so to speak. Those boys and girls that didn't do their best, some will drop out, some that stayed in didn't excel and they weren't able to pass the required math and chemistry and all. I couldn't pass it either, so I'm not criticizing them, but they are left short, and they are short on teachers because the outside world beyond the educational institution is so much more attractive in wages. It is draining off their better talent.

They are standing there, as they explained to me when I met with the group of them last week at home, they are standing there empty-handed more or less for replacements. They can't refill their ranks. I know you are familiar with that problem.

I don't want to just spend a lot of money but you have to recruit what you need and train them. What counsel do you have to offer on that point? You see that problem, I'm sure.

Secretary REGAN. Mr. Chairman, we are producing slightly more than 100,000 engineers and physical scientists a year now. Japan, which has less than half of our population, is producing about three or four times that number. Moreover, only about three-quarters of our graduates are

actually employed as engineers. The remainder go into other types of jobs.

One of the main problems that we have here is employing our engineers and then keeping their pay scale at such a rate of increase that it makes it worthwhile for them to stay in engineering. Engineers' earnings tend to flatten out. They go up fast on the payscale, then they flatten out, unlike some other professions where earnings continue to increase as time goes on.

The second thing that happens is we have a uniform pay scale in our secondary schools for all teachers, whether you teach languages, history, science, math, or what have you. It is uniform.

Now, I suggest that in private business, we never did that. We paid for the skills, the skills were demanded. If there were more demand for language teachers, they would get paid more. If there were more demand for math teachers, they would get paid more.

I don't see how we can expect to pay math teachers $15,000 or $17,000 a year when competitive industry wages for that same skill in computer operations or the like would be $20,000, $25,000, or $30,000. It just doesn't make economic sense.

So I think we have to do something about the pay scale of teachers, but you don't do that by raising the salaries of all teachers.

You raise the salaries of those teachers that are in demand, the teachers you want. This is the law of supply and demand that somehow or another I think we have to bring back into education if we are going to get the right type of teachers for the students that we so desparately need at this point.

I think also that private industry should be making more contributions to American educational institutions in order to improve the laboratory facilities. Most of our schools of engineering now are sadly lacking in good laboratories and the like.

I think an awful lot more can be done there because it is in an American corporation's own self interest to do so. They are the ones that need to hire the engineers. They would be well advised to provide some of the resources and tools needed to train those engineers. So those are my suggestions.

Senator STENNIS. You already knew what I found out lately about those two points, and the modern way to do things are machinery, I call it. That is really shocking.

Well, in looking further way out, then, you would put great emphasis on these changes you have recommended; is that right?

Secretary REGAN. Yes, sir.

Senator STENNIS. I thank you. That is all, Mr. Chairman.

Chairman HATFIELD. Thank you, Senator Stennis.

Senator Mattingly?

Senator MATTINGLY. Thank you, Mr. Chairman.

Mr. Secretary, it is good to see you here.

CHANGE IN ECONOMIC CYCLES

I think the bottom line of all of this is whether we are going to really try to break this cycle or whether we are just going to go back to the same old cycles we have had, the bad economic conditions, and the ups and downs in the inflation and interest rates.

I think everybody is trying to find the right mix to make sure that it does work. I am encouraged by the charts that you have shown me, but whether the question is retraining the people, which obviously we have to do, or increasing our trade or dealing with the cost of labor; forget about the one thing we really have to face up to, and that is the cost of this Government.

I think the figure that you cited when talking about taxes in regard to what the Congress has done in the last 2 years was a net reduction of about $10 billion a year; is that correct, between now and 1988?

Secretary REGAN. Over the period fiscal 1981–88, our figures are $77 billion over that 7-year period, about $10 billion a year net tax reduction.

Senator MATTINGLY. Well, after putting the tax incentives in and taking them out and shifting the burden back and forth and moving it around, the net result of the changes in the tax code is, as far as the amount of money coming into the Government, almost a break-even.

I mean, $10 billion around here is almost a break-even.

GROWTH OF GOVERNMENT

If we keep going through the tax policy and looking at the revenue side, we will not address the No. 1 problem of the growth of Government. I know that you are supporting the President on his freeze. I disagree with that, because I think his freeze of 6 months on COLA's, and a year's restraint on salaries is not the way to freeze the Federal budget. I think the way we freeze the Federal budget is a fair, across-the-board restraint on the whole budget.

My idea of freezing the Federal budget, if we are going to spend $805 billion this year, means we are going to spend $805 billion next year, except for the increase in interest on the national debt and because of the people coming into the social security program.

Why would it not be better to do that; to stop and see where the country is and take stock, then reform these agencies?

Secretary REGAN. Well, Senator, in putting the budget together and trying to be practical about it, pragmatic, we have, for 2 years now, made certain suggestions to the Congress as far as cutting here or cutting there, and the like, but spending has continued to rise. This year we decided that rather than try that again, that it would be better to propose a type of across-the-board spending limit along with suggested cuts in selected programs. So we suggested those to the Congress and on an overall basis we propose that the 1984 budget rise no more than inflation; no real growth in the budget.

So accordingly, our fiscal year 1984 budget calls for about a 5-percent increase overall, but a lot of changes within that limit; some programs decreasing, some increasing, but no real growth for the Federal budget between 1983 and 1984.

Senator MATTINGLY. Well, it is a $43 billion increase. That is the reality, I believe.

Secretary REGAN. That is the inflationary factor, right.

Senator MATTINGLY. We must be practical with this Government. We must try to get some long-term reliability from the Government as to where the interest rates will be in the future or that the inflation rate will stay low for a long period of time and that jobs will be secure.

What I am saying is that despite all our motion, we don't make reforms, really. We have had some reforms in the last 2 years, on tax policy, but we really do not reform the agencies of the Federal Government. We don't mandate changes in HUD and Defense or whatever agencies that we have out there. Being practical about it, I don't think that will ever happen, and I do not see why it would happen unless you froze their budgets in order to help break the cycle.

Secretary REGAN. We are attempting something a bit different. I don't think you can just say, "Everybody freeze." Certain programs cannot simply be frozen.

For example, last year, medical costs in the CPI rose at an 11-percent-plus rate.

There is no way you could freeze medicare or medicaid this year unless you were willing to cut it back more than 8 percent. I don't think you can do it physically.

BUDGET FREEZE

Senator MATTINGLY. I realize there are things in the budget that can't be frozen—but I also realize there are things in the budget that can be; that you don't freeze this sector for 12 months and this sector for 9 months and this sector for 6 months. In order to be fair, you must be consistent.

Secretary REGAN. We are proposing that social security and related programs should be frozen at a similar rate, that is, for 6 months. As an employer, the Federal Government would freeze pay and retirement for civilians and military personnel for 1 year, providing symmetry there. But I admit that freezing pay for 1 year is not the equivalent for freezing social security for the 6 months.

Senator MATTINGLY. Thank you.

TAX SYSTEM

Like Senator Stennis, I will cut it off too soon, but they also think that $805 billion is a lot of money. I will get back on that track for just a moment, but I would like to ask you something about the tax system which I greatly encourage, but I would, at the same time, say if you are going to study the tax system, whoever it is going to go to, the tax code, it seems to me that we ought to halt any changes in the tax system until such time as you finish that so we don't have an erratic tax policy that we have tried to modify in the last 2 years. But I think that the policy we put in in 1982 caused a lot of uncertainty in the private sector. I am just saying that we would be better off to at least have the private sector out there have some reliability of the tax system that was just passed and keep it intact, and not go switching it back and forth. I

know we will be coming up with more tax changes and policies this year, right, whether we are for or against it.

You want to reduce it from 12 to 6. That is a policy, and the social security policy change is a tax policy change, but I am just saying it would seem to me it would add a lot more security both to the Government and the private sector if you just halt until such time as you did complete a study.

Secretary REGAN. I don't think that you could halt, for example, the social security increases. That had been constructed and contrived on a bipartisan basis.

Senator MATTINGLY. We will strike the word contrived.

Secretary REGAN. All right, a very carefully constructed compromise in the commission, and part of that is in tax increase and part is in benefit decreases.

I think that we would have to go along with that. The primary purposes of the other tax matters that we are suggesting is not tax increases. For example, in an effort to get some control over medical expenses, we are suggesting that only $175 a month be allowed as a tax-free contribution by an employer to an employee for medical insurance for a family.

The idea of going beyond that, we think, is too much of a tax break, and it allows people to spend much too much in medical care. We think this proposal will help restrain the 11-percent year over year increase in the medical CPI.

So I would say we are using a rifle, here, Senator, in the tax code. It is affecting only 18 percent of workers, so we are not proposing an increase that would confuse or confound most taxpayers.

TRIGGER TAX

Senator MATTINGLY. Is the trigger tax a rifle approach also?

Secretary REGAN. The trigger tax?

Senator MATTINGLY. I feel a lot of people will be shot over it.

Secretary REGAN. Well, what we have proposed for that trigger tax is a 5-percent surcharge for individuals and businesses, which I think is pretty easy to understand and can be accounted for by most businesses. The other part of the contingency tax plan is an excise tax on oil, which, again, I think, might not be a bad idea by late 1985, particularly in view of falling prices and perhaps increased consumption of oil.

FRINGE BENEFIT TAX

Senator MATTINGLY. What I am saying is that we have created a lot of uncertainty, as you well know, by switching the tax policy back and forth. We create a lot of uncertainty by the way we spend money up here, too. As you know, the prohibition on the fringe benefit tax will expire on December 31 of this year. I'm sure there will be a lot of people out there concerned that if we don't go ahead and continue that prohibition they will get their free parking place taxed or their Christmas ham. That is why I recommend a freeze on taxes as well as the spending side.

Secretary REGAN. What we are trying to do, as you know, is to study whether or not we can simplify taxes for everyone. This is a Herculean job. In order to accomplish it, it must be done quickly. It is something that I think we should get on with, to see if somehow or another we could make things a lot simpler than they are now, particularly for corporations.

Senator MATTINGLY. Simple for people. Thank you, Mr. Chairman.

Chairman HATFIELD. Thank you, Senator. Senator Specter?

Senator SPECTER. Thank you, Mr. Chairman.

THIRD-YEAR TAX CUT

Secretary Regan, you testified about the third year of the tax cut, and I would like to review that question with you a bit, if I may. What savings would there be if the tax cut would go into effect July 1, 1984, or be eliminated? How much money would be produced and how much would the deficit be cut by?

Secretary REGAN. Hold on a minute, Senator. I have those figures somewhere if I can dig them up.

To repeal it fully would mean additional taxes of $6.6 billion in 1983, $28.2 billion in 1984, $30.4 billion in 1985, $33 billion in 1986 and the like.

Senator SPECTER. That is if you just repealed the third-year tax cut?

Secretary REGAN. That is correct.

Senator SPECTER. The one going into effect July 1, 1983.

COST TO TREASURY OF FIRST-YEAR TAX CUT

How much in taxes were not paid as a result of the tax cut which went into effect—I believe the first one went into effect October 1, 1981; how much did the Internal Revenue Service lose in 1981 as a result of that cut?

Secretary REGAN. Starting in 1982, Senator, the Economic Recovery Tax Act of 1981 reduced Federal receipts by $35.6 billion in 1982, $82.6 billion in 1983, $130.3 billion in 1984, $158.2 billion in 1985, $202.3 billion in 1986.

TAX LOSSES IN 1981

Senator SPECTER. You do not have the figure as to how much was lost in 1981?

Secretary REGAN. $400 million. See, remember that the tax cut didn't go into effect until October 1.

Senator SPECTER. Yes; that is what I had noted.

Secretary REGAN. Those, by the way, are fiscal years, not calendar years.

Senator BUMPERS. Senator Specter, would you yield at this point for just one thing?

Senator SPECTER. Yes; I would.

Senator BUMPERS. Thank you. The business part of those taxes went into effect January 1, didn't they, Mr. Secretary?

Secretary REGAN. That is true.

Senator BUMPERS. We lost $400 million in total tax revenue from that cut?

Secretary REGAN. That is correct, Senator.

TAX CUT REINVESTMENT

Senator SPECTER. Mr. Regan, do we have any way to know or approximate how much of that tax cut was reinvested?

Secretary REGAN. There is no way that you can definitely ascertain that, but I can tell you that there has been an increase in calendar 1982 of approximately $25 billion in IRA and Keough plans. We know that venture capital is up now to about $6½ billion, an increase of about $4 billion.

We know that the savings rate in the United States is up close to 7 percent of disposable income, up from about 4½ or 5 percent in 1980.

So it is possible to say that there have been billions, but how to quantify it exactly, I wouldn't know.

NEW INVESTMENT CAPITAL AS RESULT OF 1981 TAX CUT

Senator SPECTER. Is there any way to determine or to approximate the amount of new investment capital which was induced by the accelerated depreciation provisions in the 1981 Tax Act?

Secretary REGAN. We don't have it. It would be very difficult to trace, but we could make an attempt at that and submit it for the record.

[The information follows:]

ERTA IMPACT ON CAPITAL SPENDING

It is impossible to know the exact impact on capital spending of the accelerated depreciation provisions of ERTA. Econometricians and economic historians will be debating this point for years to come. Clearly, however, the impact has been substantial. The decline in real business fixed investment during the 1981–82 economic downturn was slightly less than the average for previous postwar recessions, even though such fundamental determinants of capital spending as rates of capacity utilization fell to very low levels, and profits were sharply reduced. The following tabulation presents changes in real business fixed investment during postwar recessions, as measured from the cycle peak to trough quarters and also as measured from the average of the four quarters up to and including the cycle peak to the average of the quarters of recession. The tabulation also compares these movements with changes from peak to trough quarters in the rate of capacity utilization in manufacturing, the utilization rate at the trough quarter, and also the share of economic profits in GNP at the trough. (Economic profits are on a before-tax basis, exclude inventory profits, and put depreciation on a replacement cost basis. Thus, this measure excludes the effect of accelerated depreciation.) Cycle peaks and troughs are designated by the National Bureau of Economic Research. The brief 1980 downturn is excluded from the tabulation.

PERCENTAGE OF CHANGE DURING POSTWAR RECESSIONS

Recession	Change in real business fixed investment		Capacity utilization		Economic profit share at trough
	Peak to trough	4 quarters, through peak to recession quarters	Level at trough quarter	Change, peak to trough quarters	
1948–49	-16.2	-4.3	72.4	-10.0	9.7
1953–54	-3.9	0.5	79.7	-11.4	9.3
1957–58	-12.6	-6.5	72.4	-13.7	8.7
1960–61	-3.8	-0.6	73.8	-9.2	8.5
1969–70	-6.0	-2.5	76.6	-9.7	6.8
1973–75	-14.2	-3.9	70.3	-19.7	5.6
Average	-9.5	-2.9	74.2	-12.3	8.1
1981–82	-8.0	-1.6	67.6	-14.8	5.3

Overall, the cyclical experience of real business fixed investment during the recent recession compares favorably with that of prior postwar downturns despite a severe weakening in the fundamentals. The only reasonable explanation for this is the investment incentives contained in ERTA.

SUCCESS IN STIMULATING ECONOMY

Senator SPECTER. Well, I would be interested to know that, by way of raising the fundamental question: We passed a very unique if not drastic revolutionary tax act in 1981, and to what extent, as we sit here 1½, almost 2 years later, can we make a determination as to how successful that has been in stimulating the economy?

Secretary REGAN. That is going to take some time to dig out, Senator, until we see the extent of recession that we were in and the causes of that recession. We would have to notice the loss of receipts to the Treasury from the recession and compare those figures with the actual tax cut and the forecast that was made for the actual tax cut based upon a different economic scenario.

You will recall that when this tax cut went in and when these figures were given to the Congress, it was estimated that we would continue to be in a plus mode of the economy during the years 1982 and 1983.

As it turned out, 1982 was one of the worst years of recession that we have had. Accordingly, receipts have fallen dramatically. It is rather difficult to say that an ACRS program would be successful in the middle of a recession when there is unused capacity and no need for new machinery or new buildings.

So there is a combination of circumstances here that historians are going to have to wrestle with. I don't think there is any fast answer that can be given to that question.

EFFECT ON WALL STREET OF ELIMINATING THIRD-YEAR TAX CUT

Senator SPECTER. Mr. Regan, as you outline the kind of savings which would be present if we eliminated the third-year tax cut, they would be very substantial.

If the third year of tax cut were eliminated and that signal was given to Wall Street, what would your judgment be as to the effect on interest rates? Would it bring interest rates down significantly?

Secretary REGAN. No, it would not. It would add more confusion.

Let me talk about that for a moment, Senator.

First of all, if you eliminate the third-year cut, as I suggested in my prepared remarks, you have an effect upon all of the 16.5 million small businessmen in this country. Eighty-five percent of them use the individual income tax form.

Right now, according to those tax tables, they are already estimating their taxes due April 15 on the basis of the tax cut coming July 1. They would have to change their entire tax system and change their tax planning at this point.

As I suggested also, raising taxes just as you are recovering from a recession, could harm the recovery because people are not going to have the money that they thought would be coming to them.

We have promised this to the American people. A lot of people have figured on it happening. As I also indicated, 72 percent of that tax cut goes to people with incomes of less than $50,000. This means that those people are going to pay more taxes this year. These are the very people that we want to be our consumers and our savers; and yet we are saying to them, "Sorry, we are going to spend it at the Federal level, you can't have it."

Senator SPECTER. You said there would be savings in taxes of $6.6 billion in 1983, $28 billion in 1984; and $30 billion in 1985, and what was the saving, again, in 1986?

Secretary REGAN. $33 billion.

REDUCTION IN DEFICITS

Senator SPECTER. If you were to find some other way to have those savings so we would reduce the deficits by that amount of money, other than the third-year tax cut, would that have a significant effect on interest rates at the present time?

Secretary REGAN. Yes, Senator. A reduction of deficits, per se, will have a good effect on interest rates; but it depends, of course, upon the way that you achieve the savings to affect the deficit.

Senator SPECTER. I understand that, and you have given reasons why you believe that if you eliminate the third year of the tax cut that it would not be the right signal, it would not have the effect on reducing interest rates.

I am trying to test that with the same saving achieved somewhere else and it seems to me we have to make an evaluation on the third year of the tax cut as to whether there would be a sufficiently significant saving on interest rates; that that might stimulate the economy and produce more.

These are very difficult judgmental questions.

What I am looking toward is your evaluation of what the effect would be on interest rates if we could have these very material savings. You have totaled up close to $100 billion, so if we were to make that saving in the outyears of $100 billion, I would expect that to have a significant impact on current interest rates, wouldn't it?

Secretary REGAN. I would agree with you, Senator. I am not sure you can quantify it, though. I cannot say that if you had $100 billion in savings and deficits, there would be a one-for-one relationship with the prime rate or a one-for-two or something of that nature.

I think we can generalize and say that yes, if deficits come down, interest rates should come down also, because the fear of inflation and monetizing these debts would be lessened.

INTEREST RATE REDUCTION

Senator SPECTER. The question in my mind is, if you reduced the deficit by that much, would it be probable to bring interest rates down under 10 percent, the magical figure that President Reagan has talked about and the magic push that that would give the economy?

Secretary REGAN. Yes, Senator, it would be entirely possible.

Senator SPECTER. That would be entirely worth achieving if that could be done in some way. We are all searching for a way to do it. One of the ways that it is presented to us is eliminating the third year of the tax cut, assuming that it would not have the other dangerous consequences which you have described, and that is the judgmental factor.

Secretary REGAN. But I submit, Senator, that raising taxes does not get interest rates down. We raised taxes—that is, we collected more from people in 1979 and 1980 than we did in 1977 and 1978—yet interest rates went up during that period because there were disincentives to savings and to investment. People began to be afraid of the amount of money that they were losing to the Federal Government and began to demand more in the way of wages and the like.

ALL-SAVERS PROVISION

Senator SPECTER. Shifting briefly to the issue of all-savers, did the all-savers bill, provision, produce significant additional savings, or did it just transfer accounts?

Secretary REGAN. All-savers, in my judgment, was a complete bust.

Senator SPECTER. Why?

Secretary REGAN. I said it at the time, and I still am of that opinion. It did not accomplish what it set out to do.

Senator SPECTER. What is your experience on the prediction?

Secretary REGAN. The experience was that it added some $25 or $30 billion in the first month and overall about $40 or $45 billion of savings into these tax-free certificates; but in tracing the money, it was never shown that new money was brought in. Rather, it was a shift from one account to another.

Senator SPECTER. Was it shown that it was not new money?

Secretary REGAN. By and large, yes.

IRA AND KEOUGH PLANS

Senator SPECTER. How about the change in laws on the retirement accounts? You referred to that earlier. Has that produced substantial new savings?

Secretary REGAN. Yes, it has. In the period of January through November 1982, the amounts in IRA and Keough plans have doubled. It has gone from about $15 billion to over $30 billion, and the estimates are, that by April 15, there will be over $45 billion in IRA and Keough accounts.

Senator SPECTER. Would it be wise to raise the amount of the $2,000 deductions and make it $3,000?

Secretary REGAN. It has been suggested that perhaps there should be some indexing of that figure or some change annually.

I think it is something that we should look at. I don't think that we should change it at this particular moment. I think funds are pouring into these accounts sufficiently. However, I think it is something that Congress should look at.

ENTERPRISE ZONES

Senator SPECTER. You also referred to enterprise zones. The legislation provides for 25 enterprise zones nationally in each of 3 years. Would it be a good idea to have substantially more than that? We are also talking about enterprise zones in agricultural areas. I know in my own State we could use 25 enterprise zones very easily. It is going to be a very difficult matter to provide 25 enterprise zones among the 50 States.

Secretary REGAN. I think, Senator, first of all, we have to get some experience with these. Each person that describes an enterprise zone seems to have something different in mind. I think the experience regionally and even within States is going to differ. I think we need to gain some experience before we go wholeheartedly and just throw money at this particular problem.

WITHHOLDING AND SAVINGS CERTIFICATES

Senator SPECTER. One final question, Mr. Regan: It involves the controversy which has engulfed us all in the 10 percent of withholding and the savings certificates, an issue which all of us hear a great deal about whether we travel in our own States or to our offices and open up the mail.

When this provision was advocated last year, my recollection is that the testimony was that it would produce an additional $6 to $8 billion a year; is that correct?

Secretary REGAN. No; withholding will increase receipts by about $1 billion in 1983, $5 billion in 1984, and about $3 billion each year thereafter.

Senator SPECTER. Has it—it has not started yet.

Secretary REGAN. It has not started yet. It won't start until July 1, 1983.

Senator SPECTER. I recently heard that the administrative costs are just enormous on the administration's plan. Do you have any information on that subject?

Secretary REGAN. We have been asking for these kinds of figures. We asked for it in November at both Treasury and the IRS. We had a big meeting on February 1. We have asked people constantly to come forward and actually give us figures that we can look at. We get a lot of generalities and a lot of ball park figures but never anything specific. Just recently I had an experience with the National Credit Union in which they claimed that these were enormous burdens, and I said I had not seen any such figures, whereupon they presented me with figures then and there. It turned out that for a credit union with less than $500,000 in assets, the cost was $1,400. With $10 million of assets, the cost was $59,000 by their own figures.

I do not think that those are enormous and burdensome costs.

The same applies to banks. Remember that in my background, I have come from an organization that has 1½ million customers and it sends out monthly statements. I know a little bit about the cost of software and the like, and I cannot find any substantiation for these hundreds of thousands and millions of dollars that the banks and others are saying this provision will raise their costs. I think this has grown way out of proportion. In addition, all of these scare stories that the elderly are going to be deprived of money that they would otherwise use for food and medicine and shelter are exaggerations.

EXEMPTIONS FOR ELDERLY

We have exemptions for the elderly. We have exemptions for those that have small amounts of interest and dividends. The problem has really been overblown by banks that simply do not want to become tax collectors. I cannot blame them. No one likes to become a tax collector. Yet that is the law of the land.

Senator SPECTER. Mr. Regan, what you are essentially saying here is that there are $4 to $5 billion where people have not paid taxes on the interest from their accounts?

Secretary REGAN. No; there is $20 billion of income. The unpaid taxes run $4 to $5 billion and withholding will reduce the unpaid amount by about half.

COLLECTION OF OWED TAXES

Senator SPECTER. All right, $4 to $5 billion of taxes have not been paid by people who owe the money. Isn't there any other way that the money could be collected?

For example, the information is supplied by the banks to the Treasury Department. Couldn't the Treasury Department collect the money from those who have not paid it in some simpler way?

Secretary REGAN. Not that we know of. We have——

Senator SPECTER. Have you tried? Have you tried writing to people, calling to their accounts and sending them a bill?

Secretary REGAN. Yes; but when you get into small amounts of money, that is $500 in taxes or less, it hardly pays to take a skilled IRS employee to track down that amount of money. We try to use our resources in the best areas available. We were having the same problem

on wages and salaries until it was mandated by the Congress that there would be withholding from wages and salaries. People did not like that. I don't see any reason why people who receive interest and dividends should not be in the same boat with those of us who work and have taxes deducted from our wages. As far as the interest differential is concerned, if you have $10,000 in a savings account and the tax is withheld, the net interest—let's say you are getting 9 percent interest—the net interest to you, after that withholding, is 8.95 percent. So literally, it is $5 on $10,000. I don't think that's really harming people in their savings when we do something of that nature. Yet the Government can collect the $3 billion.

Assume that you knock that out. Assume that, somehow or other, the Congress said, "No, we will not go with that," as they did last year. What happens? We will have to increase taxes $3 billion on otherwise honest taxpayers or we will have $3 billion in additional deficits which we both agree the country cannot stand.

FLOAT ON WITHHOLDING

Senator SPECTER. What is the value to the Government of the float on this withholding?

Secretary REGAN. Very little value to the Government. The value goes to the banks. It is going to give the banks 30 days float, but the minute the money comes in to us—remember, we borrow money weekly—we will use that cash instead of borrowing more so that there is no advantage of the float to the Government.

Chairman HATFIELD. Thank you.

Senator Bumpers?

BEARER BONDS

Senator BUMPERS. Mr. Secretary, just pursuing Senator Specter's line of questioning about withholding on interest and dividends, can you tell me what part the evasion or the evasion of taxes on bearer bonds play in that whole scheme of the amount of money that the Treasury Department says it is losing?

Secretary REGAN. Quite a bit, Senator, but the exact amount, we don't know, because we don't know how much has been paid on bearer bonds and what the amount of interest is.

Senator BUMPERS. That is a good place for somebody who doesn't want to pay taxes on his interest to avoid interest, isn't it?

Secretary REGAN. Yes; as you know, bearer bonds are being phased out by law. New bonds have to be registered.

Senator BUMPERS. Was that under the tax law that we did last summer?

Secretary REGAN. No; that was—wait a minute. Let me ask and make sure.

That was part of the Tax Equity and Fiscal Responsibility Act of 1982.

Senator BUMPERS. And they are to be phased out over what period of time, as soon as they mature?

Secretary REGAN. As soon as they mature or are called.

DISCRIMINATION IN IRA'S

Senator BUMPERS. On IRA's, Mr. Secretary, I have had at least two irate women contact me about what they consider rank discrimination in IRA's. For example, a woman is not eligible for an IRA unless she is employed or has what we call earned income. Her husband can buy an IRA for himself and her, but in not the same amount that she would be able to buy if she were employed.

Let's take a woman who has inherited money and over the years has managed her money. She invested. She has made money, and it is her full time occupation, managing her money. Do you think it is right that she should not be allowed to buy an IRA?

Secretary REGAN. No; as a matter of fact, Senator, at the time when we were negotiating this tax bill last year, that came up. At that point, you recall, we were in the middle of, shall I say, delicate negotiations between both Houses of the Congress and the administration on this tax bill. The amounts of additional revenue loss were mounting. Accordingly, IRA's were not allowed in those cases. I have a wife who does not "work," but she works bringing up a family of children. To think that she couldn't have an IRA and I could is definitely discriminatory.

Senator BUMPERS. Then you would support a repeal on that?

Secretary REGAN. I think we should certainly take a look at that.

INTERNATIONAL DEBT

Senator BUMPERS. Mr. Secretary, let's get to what I consider one of the most dangerous problems we face—you have been talking about that a lot lately—and that is the problem with the international debt and the effect that it has upon private lenders in this country. I don't know the precise amounts. Let me say on the front end, I recognize the danger of the problem, and I am inclined to do anything that is sensible and reasonable that is calculated to solve this problem, though it looks at times, to me, almost unsolvable.

Before I would vote to increase our contribution, for example, to the IMF, I would want to be sure that the banks in this country had done everything that we must reasonably expect them to do. In that category I would include, in that example I think the banks ought to be required to write off some of these loans, not necessarily jeopardizing their capital, but write off some of these loans that are obviously never going to be repaid: No. 2, something that you have very strongly suggested, I believe, and that is that they restructure and extend these loans and possibly reduce the interest rate.

It seems to me that those are two fairly minor demands on the part of the Government in order to increase the drawing fund by $30 billion and try to salvage these countries that obviously can't pay their loans.

Do you agree with those things?

Secretary REGAN. Well, in part, yes, in part, no, Senator.

Regarding the increase in IMF resources, the United States sought to keep the entire increase down. Most nations of the world were for doubling or more the size of IMF quotas. The United States was alone in its suggestion that the quota increase be only 40 percent up to about 85 billion SDR's. Most everybody else said either 100 or 125 billion SDR's. We finally came out at 90 billion. Clearly the United States position held well during those discussions.

So we have a minimal increase. As far as funding is concerned—and I know that as Members of Congress, you are rather up tight—are we going to spend out a lot of money to aid foreign countries at a time when we can't do much for our own country, when we are looking at jobs programs and other things of that nature? The rate of financing to the IMF from the United States over the last 13 years averaged less than $1 billion a year. The last 2 years or so it has increased to about $2 billion annually.

It would be our estimate that if this $5.8 billion increase in our quota is just from——

Senator BUMPERS. The administration is going to ask for $5.8 billion?

Secretary REGAN. Yes; $5.8 billion for the quota increase and $2.6 billion for the expansion of the General Arrangements to Borrow for a total of $8.4 billion. The financing rate on that $5.8 billion will not be over $1 to $1.5 billion a year in my judgment. Since this year we are going to borrow $224 billion, I don't think another $1 billion is going to break the credit markets of the country or change the outlook.

Second, the General Arrangments to Borrow is a contingency fund, a rainy day fund.

It, hopefully, will never be used. If it is, it would entail minimum financing, perhaps $0.5 to $1.0 billion a year. I don't think we need to worry about that either, but I think what we should worry about is whether or not our banks have gone too far in some of these loans.

I suggested yesterday to members of the Banking Committee here in the Senate that one of the things that we should do is to make sure that the regulators have control over the amounts that the banks are lending on a country by country basis and the like so that these excessive lending mistakes would not be repeated.

LEVERAGE OVER FOREIGN LOANS

Senator BUMPERS. I am glad to hear you say that, because that is another condition. Before I would vote for such a thing as that, I want to be sure that we were going to exercise some leverage over how great the loans are going to be in the future so we don't find ourselves back in the same position.

Secretary REGAN. Three regulators have testified before the Banking Committee today, the Chairman of the Federal Reserve, the Comptroller of the Currency, and the Chairman of the FDIC, and I have suggested to members of the Banking Committee that they talk with them about the type of regulations needed.

However, I have cautioned about trying to get into much detail as far as law is concerned. These regulators can effectively implement congressional guidelines.

INCREASE IN PERSONAL SAVINGS

Senator BUMPERS. Mr. Secretary, let me shift gears over to the economy and the budget and the effects of this, too. In Business Week magazine, which I think is a fine publication, it said last week, "personal savings went up $142 billion in 1982." That is personal savings.

Let's just assume for argument that personal savings go up $100 to $175, $180 billion this year, and that would be a much bigger increase than is anticipated. But for easy figures, let's assume that it goes up $180 billion.

How, if we borrow $210 billion this year and personal savings only go up $180 billion, are we going to keep interest rates from going back up unless the Federal Reserve Bank prints an awful lot of money?

Secretary REGAN. The figure for total private savings is substantially larger than that, once you throw in the business depreciation and the like.

Remember, it is businesses that will be doing most of the borrowing here, apart from the Federal Government. They do have depreciation and the like, so you have to look at gross savings rather than net savings and look at total savings rather than just personal savings.

Senator BUMPERS. How much do you estimate total savings will be this year?

Secretary REGAN. Total savings I don't have off hand, but I can tell you that last fiscal year there was nearly $500 billion in total funds raised in credit markets in the United States, and of that amount, including borrowing of Government-sponsored agencies and loan guarantees as well as direct borrowing, the Federal Government took about $200 billion.

So, roughly, two-fifths went to the Federal Government. There is no doubt, the more that the Federal Government takes, the less chance we have of getting interest rates down. That is why I am pleading here for reduced deficits.

THIRD-YEAR TAX CUT

Senator BUMPERS. Let me ask you this: There has already been a discussion here about the administration's--what I consider really untrackable and hardheaded position on the third year of the tax cut.

I have never understood it. We are to the point now where people like Walter Heller would say this is a very bad time to rescind the third year of the tax cut, whereas last year, people of his economic persuasion thought it was an excellent idea.

But you have pointed out in your testimony this morning, Mr. Secretary, that the third year is important because people who make under $50,000 a year and working people are going to get the big share of theirs in the third year.

The wealthy people got theirs on the front end. I agree with that to some extent, but if that is true, why would the administration at least not encourage something along the Bradley line of phasing that tax out for people who have incomes from $44,000 to $65,000?

That would save about $28 billion over the next 3 years, and at least the working people would still get their share, and the people who have already gotten the lion's share would not.

Why is that not a plausable idea?

Secretary REGAN. For this reason, Senator. And parenthetically, I think those figures are a little bit high, the high-income type of person, the person in the brackets above $50,000, accounts for much of our savings.

VENTURE CAPITAL

Those Business Week savings figures that you cite, if you broke them down by income bracket, would show that a large proportion comes from the upper brackets, and we do need those savings. We need venture capital. We know that the people in those brackets are the ones who put their money into venture capital.

We know, as I said in answer to a question from Senator Specter, that there are approximately 16½ million small businessmen in this country. These would be the people who are trying to save. Eighty-five percent of them file individual income tax returns. Roughly 50 percent of people employed in the United States are employed in small business.

What I am suggesting that instead of just thinking of these as wealthy people, you start thinking of them as primarily small businessmen who are employing, currently, about 50 percent of all workers. We know that two out of five new jobs come from these small businessmen.

Senator BUMPERS. Ninety percent of the small business people in this country make less than $50,000 a year, Mr. Secretary.

Secretary REGAN. That is net, Senator.

Senator BUMPERS. That is what I am talking about.

Secretary REGAN. After they pay for all the other things, but as far as their tax returns are concerned, in terms of their gross earnings before expenses, many are above the $50,000 bracket.

Senator BUMPERS. Here is the way I see the tradeoff. You are describing it almost as a quid pro quo, but the way I see it, you are betting and hoping that the people who make over $50,000 a year will save all of their tax cut, and I am saying they may or they may not, but if we don't give it to them in the first place, we know we can reduce the deficit by that amount.

Secretary REGAN. Maybe we can reduce the deficit.

Senator BUMPERS. If you don't give them that tax cut, we know we will reduce the deficit.

Secretary REGAN. If you will agree with me, Senator, and if we have at least a majority of the Senators who will swear they will not raise one more thing in the budget, I would agree with you. What I am afraid will happen is what happened in the seventies and the like. Each year the revenues went up and each year we had deficits. Raising

revenues does not necessarily mean lower deficits. We have to have the agreement that there will also be less spending.

Look at the bargain we made last year.

Senator BUMPERS. Just leave the budget exactly as you submitted. I assume you will get everything. If you do what I suggested, you will reduce the deficit by whatever amount we save by that.

Secretary REGAN. But you also stand the chance of reducing savings and getting less investment. That is what I am telling you.

Senator BUMPERS. I think we just disagree on that. We see it in slightly different terms.

Let me ask you another question: This is really admittedly self-serving. There are only two Senators in the United States Senate who voted for the President's budget cuts in 1981 and strenuously opposed his tax cuts in the same year, and that was Senator Bradley and I.

The New York Times had an editorial saying that if the President had agreed with that position and agreed to increase defense spending by 3 percent in real dollars plus inflation each year, that even with today's unemployment rate, the budget deficit we would be looking at right now would be $40 billion. Did you see that editorial? If you didn't, do you agree with that?

Secretary REGAN. I saw it and disagree with it.

Senator BUMPERS. Why do you disagree? No trial lawyer should ever ask why, but I am going to make an exception in your case.

Secretary REGAN. That is the benefit, Senator, of hindsight based upon a set of economic circumstances.

Senator BUMPERS. It wasn't hindsight with me. That is why I voted the way I did.

Secretary REGAN. Well, with the two of you, but with the majority, a lot of us think the other way. Perhaps you might have been right. If we had done that, things might have come out differently, but we will never know because we are looking backward. There is no way to know for sure what would happen exactly.

LOSS TO TREASURY OF 1981 TAX CUT

Senator BUMPERS. Mr. Secretary, I am getting suspicious. Senator Specter asked how much we lost in the 1981 tax cut, and I injected myself into that question. You said $400 million.

Secretary REGAN. That is correct, Senator.

Senator BUMPERS. So I asked you since the business tax cuts were retroactive to January 1, 1981, did that figure still hold, and you said yes.

According to the bill itself, we lost $1,565,000 in 1981 counting the business tax cuts.

Secretary REGAN. Wait a minute, Senator. That was based upon an estimate. What I am telling are the actual facts of what happened in that year according to the Office of Tax Analysis at Treasury. I would be more than happy to have a member of your staff come down and talk to our Office of Tax Analysis.

GE PROFITS FROM SAFE HARBOR LEASING PROVISION

Senator BUMPERS. Mr. Secretary, let me just ask you a question along that line. General Electric, as a result of that Safe Harbor Leasing Provision in that bill, had a $2½ billion profit in that year and got a $100 million refund. It seems General Electric alone may have cost $400 million.

Secretary REGAN. Again, what would have happened had General Electric not bought the machinery or enlarged the plant that would not have enabled them to expand, what is the trade off for that, how many jobs did they create? They could have accomplished something to get that ACRS credit.

Senator BUMPERS. Nobody entered into those Safe Harbor Leasing Provisions unless they could save a lot of taxes on it.

Secretary REGAN. It is funny how people will respond, if you encourage them and show them how they can reduce their taxes. That is the response we expected. We expected to get people to spend money on new plant and equipment in the United States to make us more competitive. That is exactly what I submit to you G.E. was doing.

Senator BUMPERS. I just have one or two more questions, Mr. Chairman.

One is, you have indicated in your testimony——

Secretary REGAN. Senator, may I inject this?

Senator BUMPERS. Yes.

Secretary REGAN. Some additional figures have just been given. They are from our own budget documents that have been submitted to the Congress 2 weeks ago. The reduction in tax from ERTA is about $400 million in 1981. Of the $400 million total reduction, $213 million is attributed to ACRS.

Those are the actual figures.

Senator BUMPERS. Mr. Secretary, in all fairness, I do want to state that General Electric, I don't believe the Treasury didn't actually sustain that loss until 1982. It was more the year 1982, but we didn't actually lose the revenue that year, so at least from that standpoint, I think you are right and I was in error. I am going to ask Alice Rivlin, who will be here in a minute, if she can't imagine not losing when we reduce the tax rate from 70 percent to 50 percent, for example, for individuals and then ACRS, I can't believe that we didn't lose more than $400 million. But I will leave that.

Secretary REGAN. May I quote to you what she said in her report on that? She said, "Had the tax legislation of 1981 and 1982 not been enacted, all else being equal, a large fraction of the projected deficits would not have appeared," which is what you suggested, but she underlines, "but that would have required taxpayers to shoulder a tax load of nearly 23 percent of gross national product, much more than in any postwar year."

Senator BUMPERS. I admit the load would have been greater.

Secretary REGAN. That is the point she makes in her CBO report.

REDUCTION OF HOLDING PERIOD FOR CAPITAL GAINS

Senator BUMPERS. Do you favor reducing the holding period for capital gains from 1 year to 6 months?

Secretary REGAN. We have a study in Treasury that should be ready in 6 weeks on capital gains. This was at the request of the Tax Committee. The preliminary indications seem to be that up to a point a cut in the holding period or a cut in the rate of tax brings in more revenue than it loses. That, again, is an observation that people will do what you expect them to do when you cut their taxes.

Senator BUMPERS. That would absolutely stagger me if that were true.

Secretary REGAN. We will have the study. I would be happy to share it with you, if you like.

Senator BUMPERS. Let me ask you a question along that line. I see the chairman is getting antsy about this.

Chairman HATFIELD. I would like to say that Dr. Alice Rivlin will not be here in a minute; she will be here tomorrow morning.

Secretary REGAN. I was hoping the Senator was correct.

CAPITAL GAINS

Senator BUMPERS. When I came to the Senate 8 years ago, the capital gains rate was 49 percent. We reduced it in 1977 to 28 percent, and we increased the holding period from 6 months to 1 year. In 1981, we cut the rate from 28 percent to 20 percent, and now in 1983 it is coming back again, I feel certain of that. It will reduce the rate, the time of the holding period to 6 months. Why don't we just do away with capital gains?

Why don't we just treat everything as income?

Secretary REGAN. That would be fine, Senator, because there are no capital gains taxes in Japan. There are no capital gains taxes in Germany. Great Britain has just instituted one after not having one after all these years. Most nations of the world that have been able to increase their capital stock in the post-World War II period do not have capital gains taxes. So I think that there is a lot to be said for that.

Senator BUMPERS. So you are saying no taxes at all when an investment is made and a gain is made?

Secretary REGAN. That is right.

Senator BUMPERS. I see it differently. I would like to see it abolished rather than this Mickey Mouse operation of continuing to hack away at it. What you do is give people an incentive to invest. That has been the central theme of your testimony; that you give an incentive to have 15 to 20 percent to make a true investment. That means they will put their money at a risk. When you get the rate lower and lower and the time period for holding it less and less, you reduce the risk, and therefore you reduce all the reasons for giving them this very good rate.

Secretary REGAN. Not everybody is able to extract their money in 6 months. If you put your money into venture capital involvement, you certainly cannot get it out in 6 months. You have to leave it there.

Senator BUMPERS. That is right. I do that. I'm a venture capitalist. I put my money in there with funding that I might not get it out in 1 year. The same with real estate.

Senator BUMPERS. We are doing that now, but we are saying to people, "Put your money into this thing. There is absolutely no risk and if you hit, you still get a 20-percent rate."

Secretary REGAN. There is still a risk, because of the type of investments, because of some of the risk-bearing in commodity markets, things of that nature.

Senator BUMPERS. This could cost between $200 million and $500 million, and I think you are off from the margin by 100 percent.

Secretary REGAN. I would be glad to share the study with you.

TUITION TAX CREDITS

Senator BUMPERS. I'm anxious to see the study.

Do you share the President's policy to issue tuition tax credits?

Secretary REGAN. Yes; we do.

Senator BUMPERS. How will we ever get the deficit down?

Secretary REGAN. By cutting spending, Senator.

Senator BUMPERS. What difference does it make if you cut spending if you give the store away?

Secretary REGAN. Giving the store away, that is about $800 million in tax credits.

Senator BUMPERS. Tuition tax credits.

Secretary REGAN. That is right.

THIRD-YEAR TAX CUT

Senator BUMPERS. I am really troubled by the administration's hardheadedness about the third year of the tax cut, about continuing to talk about cutting spending and you are cutting the programs that people who have been the hardest hit by this depression depend on most, cutting those programs by 14 to 19 percent, increasing defense spending by colossal sums and then coming in here and saying, "We will cut capital gains rates," and we know who gets the benefits of capital gains taxes and tuition tax credit. There is another $500 million or $1 billion, whoever's figure you want to accept.

It seems to me these are really contradictions, and I am gravely concerned about them.

Secretary REGAN. You have got to remember the people we are trying to help with the tuition tax credits are not the wealthy people, because there is a cap there on the amount of income. It phases out between $40,000 and $60,000. That will be the cap on tuition tax credits. So there is not any benefit going to the wealthy.

Chairman HATFIELD. Thank you, Senator.

Senator Abdnor?

Senator ABDNOR. Thank you, Mr. Chairman. I will be brief. We have had quite a long morning here.

I was late. I misjudged the snow and the roads. I thought I knew snow.

Secretary REGAN. I guess people from South Dakota aren't that knowledgeable about snow.

Senator ABDNOR. I just spent 10 days in very beautiful weather. We had it up to 72 degrees in Rapid City. I thought you would like to hear that.

Secretary REGAN. That is what I mean.

Senator ABDNOR. In the colder areas, it will be in the 40's and 50's.

Chairman HATFIELD. What is beautiful in South Dakota, 40 below?

Senator ABDNOR. Forty above. It is on rare occasions when the temperatures goes down like that.

TAX WITHHOLDING

I guess you have covered most of the subjects this morning. I know that obviously, with the dividends and interest rates, withholding has come up several times. Let me tell you. I am a guy hitting three and four meetings a day, and I have never been so overwhelmed by the public on an issue than that.

Someone has done a great job of telling the people, and I saw a lot of people because I sent notices that I would be in the various towns, and they were there. They had lines. Even though they told me the same thing, I tried your arguments, and it didn't seem to do very much good to satisfy them. They talked about tips as well and that has been brought up today. I don't think IRS personnel have ever been out to South Dakota. The IRS picked the figure 8 percent out of the sky, I guess. Eight percent of a tip in South Dakota is really something.

I don't mean to suggest we are a bunch of cheapskates, we are just not accustomed to giving out big tips. They have got some very conclusive evidence to show that these waitresses don't get 8 percent in tips. By the time you take more than they have earned, you are in trouble. I don't know how you attack that problem, but I guess I will have to ask IRS people to come and talk to some of the restaurant owners and figure out what we do with mad waiters and waitresses.

Comparing it to how it is in Washington to go out to meals, sometimes it costs you $100 for a party of four or five for dinner. Sometimes they even figure your 15 percent in just before you even see the bill. That isn't quite the way it works out in South Dakota. Lunch and morning business doesn't bring any tips.

That is a little on the better part of the tip. But for taxes on people, it hasn't even been received. You said a moment ago, when they don't pay their share, then we have to tax innocent people who are already paying, but in this case, we need to take the income away from people who don't owe it.

Secretary REGAN. Senator, I will be more than happy to supply people from the IRS or any time the Senator or staff would like to go out to talk to people to investigate to see if we aren't wrong.

Senator ABDNOR. That would be an interesting subject. Sometimes, you know, I have often said when we have talked about this, that the people who make the regulations spend a month living and working with them, and there is a difference in it. I would like to see what

would happen. I don't mean to say it sarcastically, Mr. Secretary, but things are so different in different areas of the country.

TRADE DEFICIT

Let me get on one other thing I don't suppose we have talked about today, the trade deficit: What is it going to be in 1983?

Secretary REGAN. Depending on the value of the dollar and how fast we recover, there are some estimates that go up to the $65 billion level in the trade area. On a current account basis, of course, less than that.

PIK PROGRAM

Senator ABDNOR. I guess this brings me up to another one of the findings I found when I was out in South Dakota. The farmers are generally very enthused about this PIK program. They discussed it at length at the Irrigators' Convention I attended. The farmers raised big crops of corn along the rivers because they irrigate.

Almost all of them are in favor of it. As a matter of fact, the only thing that might prevent it is the percentages are going up on the corn in the last few weeks. It is causing the farmer to think maybe they better delay their planting and planning. But it does look good, and I would like to commend Secretary Block and Ambassador Brock for the wheat flour arangement that they worked out with Egypt.

I don't know how you felt about that.

Secretary REGAN. We went along with that. We thought the wheat flour sale was in our interest, although it has made for bad relations with the EC.

Senator ABDNOR. I think it's time we let them know we are around. This gets a bit old. If we did everything above board, then we would get taken advantage of. For heavens sake, we just did to them what they did to us for years with lowering interest rates and dumping grain on foreign markets.

Secretary REGAN. Senator, may I get something into the record here on the PIK program that involves the IRS?

Senator ABDNOR. Yes.

Secretary REGAN. As the law is now written, most tax people think that this would be considered income to the farmer the moment he took the corn or other commodity under the PIK program. There is definitely a need for a change in the tax code. I understand that Senator Dole and others will be introducing such a bill. We will wholeheartedly support such a bill so that the commodity receipts will not be considered income until such time as the corn, or whatever, is sold; rather than have it declared as income the moment it is received from the Government.

Senator ABDNOR. Let me assure you that is good news to hear, because they are very, very concerned about that.

Secretary REGAN. We have not made the ruling at the IRS at the current moment, but there is no question in my mind if we had to make a ruling which way it would go. I think a tax code change early on is in line. Very definitely, we have not done so yet.

Senator ABDNOR. Very good. I am happy to hear this, because this could be a factor in the success of the PIK program, because it is important to control when you want to make a sale.

Let me ask you this: If this takes off and works and farm prices start moving up, and they will—I have introduced legislation that would put as many dollars and bushels in corn sales in the export PIK program as we do in cutting back production. I think it is important.

But if farm prices started going up, how would you feel about it? Would that bother you at all? It seems to me what I am saying is we are always apologizing to the consumers that this should not make the price of food go up much. How do you react to that?

Secretary REGAN. If you look at last Friday's price report, producers' prices for foodstuffs and feedstuffs were down again in January; they are now lower than a year ago. I would not think that a modest rise in commodity prices, either food or nonfood, with the possible exception of oil, could cause our Consumer Price Index to rise sharply.

INCREASED FOOD PRICES TO CONSUMER

Senator ABDNOR. Mr. Secretary, let me just say this. I am a farmer. I know something about this. The farmers can't go on forever absorbing the cost to keep the food prices down. Sometime consumers are going to have to start paying a little bit more for the food. Some of these people are getting less today for the price of their products than they got 10 years ago.

The extreme cost of petroleum is starting to drop a little, but the fertilizers, machinery, and everything they are buying—I don't mean to be giving a lecture—everything goes up, and everybody thinks the food prices are supposed to go down. I don't understand why food is singled out as the one thing that can't go up, farming machinery can, clothes, cars, everything goes up, but we don't let food go up.

INCREASED FARM PRICES TO MIDDLEMAN

Democrats and Republicans alike apologize. These people can't go on raising food for nothing. We make sure the middleman gets to increase his cost. He adds to the price of the food. In most cases, that is where the extra price of the food has gone. It gives me a chance to talk to you about this. I talked to you once before about the farmer-food situation.

Secretary REGAN. I am not one to say that the farmer should not get more for the price of his food, particularly if he is producing it below cost. But we also recognize that food prices are affected by the middleman's costs—the costs of processing, transportation, wholesaling, and retailing.

I think there has been a greater increase in the retail food price than there has been in the farm price of foodstuffs.

Senator ABDNOR. I am glad to hear that. At least let me say this: The share of the dollar that the farmer gets is only about one-third. If it all went to the farmer, you would still have a fairly good increase and still not affect food that much.

Over in Europe, I spent a few days in Europe talking with the European leaders, farmers, and citizens. These people spend 22 to 28 percent of their take-home pay for food. In this country, they average about 13½ percent. What a bargain it is. That is why I argued with you about a tax cut one time. The farmers make it possible for people here to put money into other areas of the economy.

I am sorry, Mr. Chairman. I said I was going to be brief, but I got my point made here.

Chairman HATFIELD. Thank you, Senator.

Senator Leahy?

GOVERNMENT SPENDING POLICIES

Senator LEAHY. Thank you, Mr. Chairman, Mr. Secretary.

I was in a meeting this morning in Vermont before I came down here, and I hope that you or members of your staff might get a chance to get out of the snowbound Washington to places like Vermont.

I recommend Vermont to the administration because it is the most Republican of all States. You would do well to hear some of the concerns of people's minds about the economy and exactly what is happening.

You are well aware of the fact that the administration has consistently attacked Government spending as being inflationary. You pulled out all the stops last year to pass a constitutional amendment to require a balanced budget, at the same time setting up the biggest deficits in the Nation's history.

In this year's message, the President attacked jobs programs. He said, and let's quote, "We cannot afford major new programs, particularly in our current budgetary straits," and then went on to call a $5 billion jobs program too expensive. But a $35 billion defense increase is not.

How is it that a $5 billion jobs program would damage the economy but seven times that figure in the defense increase doesn't damage the economy? Or, am I misreading the President?

Secretary REGAN. I think that the two don't equate for these reasons. First of all, the jobs program that the President had in mind, Senator, was a make-work type of program where, literally, the Federal funds would be wasted. The President has no objections to a jobs program that merely speeds up, for example, some of the works projects that are already in the budget, such as Corps of Engineers type of projects, GSA types of projects, things of that nature.

As far as defense is concerned, I think that the President, as Commander in Chief, has decided what he thinks is necessary for the defense of his country. I, being a member of his Cabinet, obviously support his reasoning on that. I am Secretary of the Treasury, not Secretary of Defense. I am not prepared to argue dollar for dollar exactly where each dollar is needed.

DEFENSE SPENDING

Senator LEAHY. I am not expecting that you as Secretary of the Treasury would be able to explain a $0.5 billion cost-overrun on the F–18, a plane that still does not fly, or I don't expect you to be able to

explain a $250,000 flying Edsall like the B–1 bomber or any of those other things, but as the Secretary of the Treasury, you have got to look at our defense spending. I want to point out that above our commitment to NATO, above the commitment to NATO, we are adding $0.5 trillion to the Federal budget. As Secretary of the Treasury, you cannot ignore what the defense budget is costing, can you?

Secretary REGAN. Oh, no, no. Frankly, we have to finance it, but we do also know that the share of the gross national product that is going to defense, even with the expenditures that you suggest, is no higher now than it was in the sixties or early seventies.

Senator LEAHY. Wait a minute. We are not in the war of Vietnam now, but we are talking about defense spending above our commitment to NATO, adding $0.5 trillion, $500 billion or $500,000 million to the Federal budget.

Do you really feel, in your Cabinet meetings, that this kind of defense spending is justified in our economy and our budget with the resources that we have in the United States?

Secretary REGAN. Well, in fashioning the budget, as you know, there was a commitment from the Defense Department to cut back $55 billion over the 5-year period from projected outlays that originally had been suggested by them in order to try to keep these budget deficits down.

Senator LEAHY. Big deal. They ran the defense budget up to a figure that you couldn't even believe, that nobody could believe, and then say, "Well, we will whittle back a little bit. We will keep right on having programs that will have cost overruns; we will keep right on having programs that don't work. We will keep on putting gold-plated missile systems in, and we will cut back a little bit. We will cut everybody's pay. At a time when we are trying to make an All-Volunteer Force, we will keep on with the weapons systems that don't work, but we will cut everybody's pay."

Are you convinced that every weapons system that we have in the defense budget is necessary?

Secretary REGAN. I am not prepared to answer that, because I haven't really made a study of these.

I will point out to you, Senator, that they are not cutting pay. They are merely putting a freeze on pay. I can recall being in the service and not getting a pay increase every year. We have inflation down now. The Armed Forces have had good pay raises over the last 3 or 4 years, so a break of 1 year, I don't think, is going to do that much harm to their overall income.

Senator LEAHY. Do you feel that that was something that would have been recommended by the Joint Chiefs of Staff?

Secretary REGAN. I have no idea.

Senator LEAHY. Do you ever notice any articles that were in the Wall Street Journal, Time, Newsweek, U.S. News, CBS, ABC, NBC, Neutral, and so on, that say they were never consulted?

Secretary REGAN. I saw that and read those articles, again, but I haven't asked the gentleman in question, so I couldn't reply.

Senator LEAHY. I understand, but you do concede that it is important for the Secretary of the Treasury to know what is being spent in the defense budget?

Secretary REGAN. Very definitely.

Senator LEAHY. And if we are borrowing a large part of a $1.7 trillion defense plan over 4 or 5 years, that is something that may be of importance to you?

Secretary REGAN. We are borrowing for the budget as a whole, and my question——

Senator LEAHY. You don't think the defense budget is a major part of that?

Secretary REGAN. $400 billion of the fiscal year 1984 budget goes to payments to individuals and another $245 or so to defense and about half of the remainder is interest.

GREATEST INCREASE IN CURRENT BUDGET

Senator LEAHY. Where is the biggest increase in the budget this year? Which item? Is it defense?

Secretary REGAN. I believe so, but hold it. I just want to make sure of my figures. Net interest rises about 16 percent and defense rises about 14 percent. Defense would rise from about 27 percent of the budget out to about 34 percent between 1983 and 1988 according to the budget, whereas payments for individuals would fall from about 49 percent to about 46 percent. Other grants fall from about 6 percent to about 4½ percent and net interest rises from about 11 percent to about 12 percent.

Senator LEAHY. And if we keep on having $200 billion deficits, we can count on that interest rising even more.

Secretary REGAN. We hope we won't continue to have that. Our analysis indicates that we can get those budget deficits down toward $100 billion in the out years with the adoption of the President's budget.

PRESIDENT'S PLAN FOR BALANCED BUDGET

Senator LEAHY. But Secretary Regan, I have a great deal of respect for you and the work you do and for you as a person. But, let me bring you back a couple of years when we were having similar hearings and we were told if we adopted the President's plan, that if we didn't have a balanced budget by 1983, we certainly would by 1984.

The President then went on and stated that if there was anything that came through the Congress that he didn't approve of, that he would veto it. He even went on to veto, because of one-half of 1 percent or less in a continuing resolution. He vetoed it and we spent approximately $1.2 million to shut the Government down and we sent a recorded message to the White House. It was a televised message, better than the Winds of War. It was the "Winds of the White House," and we ended up spending that.

The President proved his point, though, that nothing was going to go through in a budget package he didn't approve. So he got what he wanted, and now, instead of a balanced budget, we are facing a $200 billion deficit.

Is that economic recovery, or do we have some real reason to fear? I ask these questions because for the last 12 days, I have been going from 6 every morning until midnight or 1 throughout the State of Vermont meeting with every type of group there is, and that's the question I keep getting asked by everybody up there.

I wish you could have been there. I would love to have known what the answer was.

Secretary REGAN. It is much more pleasant to be in New Hampshire than in Washington.

Senator LEAHY. Vermont, please. New Hampshire is where people go to run for President. Vermont is where people go to conduct business and ski.

Secretary REGAN. Vermont, then. I am looking for previous forecasts, other than the administration's, and in the same year in which we were projecting our figures of growth in the economy and the like, practically all other economists were also projecting—well, maybe not as much as we did—but they were all on the plus side for 1981 and again for 1982. No one, except a very few of the economists of this country, and the econometricians, predicted this recession.

The majority of the loss of receipts that came about was due to the recession. In terms of the full employment budget, consider that $25 or $30 billion is the loss of revenue for 1 percent of unemployment. You can quickly see that the 5 percentage points of unemployment accounts for the majority of the deficit. The explanation lies in the fact that we did have this recession.

That is why we are saying that as bad as it is, we can handle the deficit of this year, but we think that as we return toward full unemployment and as the economy of the country recovers, we cannot afford to keep up the same type of deficit.

EMPLOYMENT

Senator LEAHY. What do you consider full employment?

Secretary REGAN. We think now somewhere in the neighborhood of 6 to 6¼ percent. I think for budgetary purposes we use 6¼.

Senator LEAHY. But even if we had that, if you go on the projections that you have in your budget, 6 years down the way, according to what percentage of the GNP we are spending, what percentage of the GNP we are raising in taxes, and 5 or 6 percent unemployment, aren't you still talking about deficits 5 years from now of $50, $60, $70 billion a year?

Secretary REGAN. Based upon our growth scenario, that is correct. But at that point, you see, we will have a $5 trillion economy, approximately, so a $40 billion or $50 billion deficit would be 1 percent or less of the gross national product.

Senator LEAHY. I am not sure that I believe that this recovery that you are talking about is anywhere near strong enough to do that. We are talking about 1984, 4 million more people unemployed than there were in 1979, if I am correct.

I have heard economists saying that, with the low growth rate forecast, it is going to take about 10 years just to digest the idle capacity that exists today, not to create new.

Is the administration saying that we are going to have to lower our expectations, accept low growth and high unemployment for the foreseeable future?

Secretary REGAN. Our official forecast is very modest for the first two or three quarters of the recovery. Then it goes to 4 percent, and we projected that 4-percent rate on into the out years. A 4-percent rate of growth in the economy 3 and 4 years after the recovery gets started is greater than in previous postwar recoveries, on average.

We think we will start off slowly in this recovery, but then we will continue to grow so that eventually this will be a better recovery than the average of the post-World War II recoveries.

Senator LEAHY. But you are saying it will lower the expectations of the American people.

Secretary REGAN. We are not saying that.

Senator LEAHY. What are you saying?

Secretary REGAN. We are likely to start off slowly. As far as unused capacity and things of that nature, remember that only one-fifth of our work force is now in manufacturing. Most of us still think in terms of manufacturing being a great employer of people, but our service-producing industries, including our information-utilizing industries, produce jobs for 70 percent of us. Growth can come from the service sector even with the unutilized capacity of manufacturing.

INTEREST RATES

Senator LEAHY. Would you say that our interest rates are comparable to where they had been when we started to recover from other recessions?

Chairman HATFIELD. Would the Senator yield just for one moment?

Senator LEAHY. Yes.

Chairman HATFIELD. Just to set up the schedule. We will not be able to hear Mr. Feldstein at 12:15.

We will try to reschedule him tomorrow with Alice Rivlin at 9:30 in this room.

Mr. Secretary, I want to thank you once again for being here today. Thank you.

REDUCTION IN REAL INTEREST RATES

Senator LEAHY. We can go back to the question: What about interest rates now and coming down, real interest rates?

Secretary REGAN. Real interest rates are much higher than they have been at this stage of any other postwar recovery. I think it's due to two causes: One, a lack of precise knowledge as to where monetary policy is going. There are fears in the market that monetary policy is too erratic; it may even be too easy at this point.

The second fear, of course, is of these deficits and from not knowing exactly what the administration and the Congress will do about these deficits, particularly in the out years.

16-439 O - 83 - 5

Senator LEAHY. But they have been able to count in the past on what happened and it was precisely what the President said would happen. He has gotten exactly what he wanted according to his own statements. Shouldn't he be able to rely on that, just go by exactly what he wants, and go by that?

Secretary REGAN. There are many indications that the Congress may not go along with his tax program. Many people are talking as if the contingency tax is not something that they will favor nor for which they will vote.

Also, for example, many people are calling for doing away with indexing or even the third phase of the tax cut. This is causing uncertainty. Thus the President may not get all of his 1984 budget.

Senator LEAHY. Should we do away with indexing?

Secretary REGAN. Absolutely not, in my opinion, Senator.

Senator LEAHY. Do you feel that if these interest rates stay so much higher than in other recessions, that that will be a major factor in slowing recovery?

Secretary REGAN. That is one of the reasons why we are projecting a rate of growth in the economy that is slower at the start than in the average of post-World War II recoveries.

Senator LEAHY. Does the President intend to try to influence the Federal Reserve's high interest rate policy?

Secretary REGAN. The President has talked with the Chairman of the Federal Reserve. I have talked with the Chairman of the Federal Reserve, and we have asked for accommodation in attaining steady growth in the money supply—positive growth, not negative. We would like growth to be steady so that money markets come to have some more certainty than they have at the current moment that a steady noninflationary policy course will be followed in the years ahead.

Senator LEAHY. Thank you very much, Mr. Secretary.

Senator CHILES. Mr. Secretary, I will have a chance to see you tomorrow morning, so I think I will just wait and talk to you there.

Secretary REGAN. I think I said I was looking forward to the Budget Committee hearings. [Laughter.]

Senator LEAHY. If you believe that, you believe in the Easter bunny, too.

SUBMITTED QUESTIONS

Senator CHILES. The chairman has instructed me to inform you that additional questions will be submitted to you for response in the record. They will appear in the record at this point.

[The following questions were not asked at the hearing but were submitted to the department for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY CHAIRMAN HATFIELD

Q. A very large and highly publicized group of prominent and experienced Americans has argued that the Administration's plan to reduce projected deficits in FY 1985 to $194 billion is not sufficient. They believe a reduction to about $75 billion is required to restore confidence in the economy and assure a recovery. What is your reaction to the proposal?

A. I assume that the question refers to the so-called "Peterson Group," named after former Secretary of Commerce Peter Peterson. I believe that the expression of views by this distinguished bipartisan group of government and business leaders is a positive contribution to the debate on economic policy. The central theme of their statement, that the fiscal problem we face requires action, is a view that I share. Inevitably, there are some differences between the specific proposals made by the bipartisan group as compared to the proposal made by the President. But there are also some important similarities.

We agree that major structural reforms are needed in entitlement programs, including restraints on cost-of-living increases such as those proposed in the President's budget and by the Social Security Commission. We also agree that economy should be sought in national security spending. Again, the President's budget includes such a proposal. And we agree that the driving force of the deficit reduction program must be to cut back the growth of Federal spending. The President has expressed this view in specific terms in his most recent budget.

However, we do not agree that it is prudent to attempt to raise taxes in FY 1985. To adopt this part of the bipartisan group's plan would be to risk aborting the recovery before it has a chance to gain momentum and provide the basis for long-term growth which, after all, is our common objective. The bipartisan group's statement is ambiguous about retaining the third year of the tax cut and indexing the income tax, two pieces of tax legislation which I support absolutely. The group proposes to augment the current tax system with consumption-based taxes which, they say, would raise an additional $60 billion of revenue in 1985. To do so would lower the purchasing power of consumers at a time when the unemployment rate will probably remain above 8 percent. Therefore, I would not support such a proposal.

In my opinion, the President's FY 1984 budget projects a path of deficit reduction in the outyears that will fit well with a pattern of enduring economic growth. I would urge the Committee and the Congress as a whole to adopt the President's program.

Q. Given a major sustained reduction in the price of imported oil, what would be its effect on the recovery and on employment? How long before the effect will be noticeable?

A. A major sustained reduction in the price of imported oil would have a significant positive impact on the overall U.S. economy and the recovery that is underway. A decline in the cost of energy would stimulate an expansion in aggregate output and employment. In effect, it would be the reverse of the so-called oil drag that occurred as a result of the oil price increases in 1973-1974 and 1978-1979. Of course, there would be some losers among the gainers in this situation. Income would be shifted from foreign and U.S. oil producers, and from governments that levy taxes on oil, to U.S. oil consumers.

The timing of the effects on the recovery depends in part on the timing of the price reduction. Some effects perhaps already are being felt as oil prices soften. If the greater part of the price reduction occurs relatively early in 1983, economic growth and the recovery in the first half of 1983 would be faster than otherwise and growth for the year as a whole would be measurably higher. Faster growth would increase employment and reduce the unemployment rate below what was forecast in the 1984 budget.

It is difficult to quantify the impact of an oil price reduction on the GNP and employment. A 20 percent price cut early in 1983 might increase the level of real GNP by somewhat less than 1 percent in 1983, followed by a small further increase in the level of GNP in 1984. The unemployment rate for 1983 might decline by somewhat less than 0.5 percentage point.

Q. Recoveries are often accompanied, in their early stages, by inventory restocking which boosts output. Is this process going to be hampered by the high cost of financing inventories (which is an unusual aspect of the past recession)?

A. Typically in the latter stages of a cyclical downturn, businesses draw down inventories very sharply. The latest downturn followed that pattern, as inventory decumulation hit record amounts in the fourth quarter of 1982 on top of large reductions in the first half of the year. Typically also, inventory decumulation continues into the early stages of recovery, then swings to moderate accumulation. Generally, it is only after the economy is a year or two into recovery that inventory restocking begins to proceed at a rapid pace so that inventory-sales ratios begin to rise.

A similar pattern appears likely during the recovery now underway. Inventory investment should swing from massive decumulation late last year to modest decumulation early in the year and then to moderate accumulation later on. Output will, of course, rise as businesses begin to meet sales out of production, rather than by drawing down stocks as they did in the fourth quarter. Because price behavior is likely to remain moderate and because it will be some time before rates of utilization of industrial capacity move back up to the range where delivery times lengthen measurably and bottlenecks begin, there will be few incentives for inventory building. Thus, the rate of accumulation might remain modest during this recovery for a longer than usual period.

We believe the typical swing to modest rates of inventory accumulation can readily be financed. As the recovery proceeds, however, it is imperative that Federal deficits be narrowed in the manner we proposed in the 1984 Budget, so that investment in plant, equipment, new homes, and in inventories can proceed at a healthy pace.

Q. The Administration forecast for average unemployment for 1983 is 10.7%. After release of the January figures, and President Reagan's assertion that we will not again see 10.8% rate, are you ready to revise the 10.7% figure?

A. In the forecast underlying the 1984 Budget we projected an unemployment rate averaging 10.7 percent for the year 1983 and reaching 10.4 percent for the fourth quarter. This series, which is on the newly revised basis to include the armed forces stationed in this country in the labor force, was at 10.2 percent in both January and February. Clearly, we were overly conservative when we put together our forecast late last year. The economy has turned around earlier and more strongly than we expected then. Neither the full extent of the inventory drawdown late last year nor the extent of the improvement in final sales was evident at the time the forecast was prepared.

We are now in the process of reassessing the economic outlook for the current year and beyond. If it appears that events are diverging sufficiently from our forecast path

so that the budget will be materially affected, we will present revised economic assumptions with our April update of the budget.

Q. How long do you believe we can permit money to expand at the rates seen in the last half of 1982 without an inflationary spiral? Is the Federal Reserve being too accommodative by trading short-term economic gains for another bout of inflation in the future?

A. Achievement of a particular desired path of monetary policy is always a complex problem because our knowledge of the magnitude and timing of the impact of monetary actions and the lag in their impact is highly imperfect. Thus, without great care, there is a risk that monetary policy could err either by being overly expansive or overly restrictive. In the first case, the gains we have made in reducing inflation could be lost; in the second, economic recovery could be aborted.

We all agree that promoting an economic recovery is the primary aim. Nevertheless, it is clear that money growth cannot continue at the pace of the latter part of 1982. The risk, however, is that an attempt to slow money growth too quickly might result in a faltering of economic recovery as the monetary squeeze impacted short-term interest rates. Economic expansion cannot proceed without the support of adequate liquidity.

Excessively expansionary money growth carries equally unpleasant economic dangers, however. While there may be limited short-run successes in such a policy as long as long-run inflationary expectations do not move adversely, predicting the behavior of market expectations under such circumstances is very difficult; and stimulative money growth can ultimately turn into excessive growth driving inflationary expectations and interest rates sharply higher. The result is a limitation of real economic growth and the threat of another downturn.

Given the inaccuracies of economic forecasting and the deficiencies in our knowledge about the timing and impact of monetary actions, it is extremely difficult to determine the moment when helpful monetary stimulus becomes harmful and inflationary. Despite these difficulties, however, we feel that the money growth target ranges for 1983, announced by Chairman Volcker in mid-February, are consistent with our goal of providing enough money growth to support the expansion, but are not so rapid as to risk reigniting inflationary pressures. Gradual slowing of money growth is consistent with the goal of both the Administration and the Federal Reserve of achieving a noninflationary pace of money growth over the long run.

Q. Does the Administration view the present rate of inflation as tolerable, or is it a major objective of the Administration to lower it further, as Milton Friedman and others have proposed?

A. We believe, and I think nearly all economists would agree, that the long-run performance of the economy would be improved if the trend of inflation were to be zero. The experience of the last several decades has taught us that inflation breeds uncertainty and leads to a wasteful diversion of resources to the avoidance of effects of inflation. Thus, inflation is detrimental to the long-run performance of the economy.

While a long-run goal is the winding down of inflation to a zero rate, the overriding immediate goal must be the establishment of a solid, sustained economic recovery. We hope and believe that inflation can continue to be reduced even as the economy moves along an expansion path. Of course, it is imperative that inflation not be allowed to reaccelerate during the recovery now getting underway. That would put us back on the same inflationary roller coaster that carried us into the period of economic stagnation from which we are only now emerging.

Q. Your statement indicates that the Administration will be searching for ways to simplify the tax code over the next year. Can you indicate some of the possibilities that exist for such a simplification?

A. I have directed my tax policy staff to study ways to restructure the entire tax code in order to accomplish the significant degree of simplification the President seeks.

This study will explore in more detail the kind of uniform tax structures described in Assistant Secretary Chapoton's September 28, 1982 testimony before the Senate Finance Committee. The general design of those uniform tax structures includes two basic elements: broadening the tax base by taking away many of the special exclusions, deductions, and credits that currently cause income to be taxed quite differently, depending upon its sources and uses; and, lowering the tax rates that would apply to income once it is properly measured. Special attention will be given to the uniform tax on consumed income and to the single rate, or flat rate, tax structure because our investigation to date indicates these features may contribute considerably to the simplification objective.

Q. Your statement asserts that real wage growth is being restored, and that there have been improvements in productivity growth and savings behavior. Will you please elaborate on these points.

A. Marked improvements have been registered in all three areas. Real wages have begun to increase after several years of decline. Perhaps the most reliable measure of wage rates is taken from the employment cost index compiled by the Bureau of Labor Statistics. It is adjusted to hold constant

the composition of employment, and the wage and salary component of the index is based on straight-time hourly earnings only. Its movements are compared in the following tabulation with changes in the consumer price index for all urban consumers.

Percent Change, December to December

	CPI-U	Wages & Salaries*	Real Wages & Salaries
1977	6.3	7.0	0.7
1978	9.0	7.7	-1.2
1979	13.3	8.7	-4.1
1980	12.4	9.0	-3.0
1981	8.9	8.8	-0.1
1982	3.9	6.3	2.3

* For workers, in the private nonfarm sector, based on the Employment Cost Index

Other measures also show real earnings growing in 1982 for the first year since 1977.

During the second half of 1982, labor productivity (output per workhour) of all persons in the business sector increased by a 3.8 percent annual rate. Excluding the somewhat volatile farm sector, productivity increased at a 2.8 percent annual rate. Measured fourth quarter to fourth quarter, productivity growth during the entire year 1982 was the strongest since 1977 when the economy was still recovering from the 1974-75 recession. (See tabulation on next page.) The 1982 performance was remarkable in that it occurred while the economy was still in recession. Typically, weakening economic activity is associated with a weak productivity performance.

Percent Change in Productivity, fourth quarter to fourth quarter

	Total business sector	Nonfarm business sector
1977	2.6	2.6
1978	0.2	0.3
1979	-1.6	-1.9
1980	0.2	0.3
1981	0.9	-0.1
1982	2.0	1.7

The combination of improved productivity and slowing rates of growth of nominal (though not real) wage rates and other elements of worker compensation has resulted in a dramatic deceleration in growth of unit labor costs to 4.4 percent last

year (fourth to fourth) for the entire business sector. This was less than one-half the rate averaged during the prior four years. A reduction in growth of unit labor costs is a prime element of any permanent slowing of price inflation.

The personal saving rate has also registered improvement, and this can be directly traced to reductions in tax rates and almost certainly also is related to deregulation in the financial area so that households are now generally able to obtain market rates of return on their savings. The personal saving rate held in a narrow range of 5.8 to 6.1 percent during the years 1977 through 1980 and in the first three quarters of 1981 averaged 6.0. It jumped to 7.5 percent in the fourth quarter of 1981 following the initial phase of the tax cuts and for full year 1982 was 6.6 percent.

Q.

During the 1960's, federal borrowing as a percent of total funds raised in U.S. credit markets was about 8%. This figure rose to 15% in the 1970's and 19% in 1981. What was the 1982 figure, and what estimates can be made for 1983 and 1984? Ideally, what percent of total funds raised should the government consume, and how do we get there?

A. The average percentage of Federal borrowing from the public to total funds raised by nonfinancial sectors has risen over the last two decades and more. However, these averages mask wide fluctuations, especially in the decade of the 1970s, when the percentage varied between 1.1 percent in FY 1974 and a peak of 34.1 percent in FY 1976. So far in the 1980s, the percentage has been on the high side, viz: 19.4 in FY 1980, 18.7 in FY 1981, and 33.2 percent in FY 1982. The higher percentages since 1960 have all occurred during periods of economic slowdown or recession and its aftermath, when private borrowing slowed down and Treasury borrowing picked up. Similarly, the low percentages are associated with periods of high economic growth, when Treasury borrowing slackened and private borrowing expanded strongly. It is true that there has been a jump in the average percentage since 1974, from a 9.0 percent average for the fiscal years, 1970-74 to a 22.0 percent average for the fiscal years 1975-82. This is partly because five of the eight years 1975-82 were affected by recession or its aftermath. Also, the percentage for FY 1983 is rising; it was 50.7 percent in the October-December quarter of 1982 (seasonally adjusted) and will probably average at least 40 percent for FY 1983, depending upon how the recovery develops.

Under the President's program, however, even though Treasury cash borrowing from the public declines only slowly during the fiscal years 1984 to 1986, the percentage should drop appreciably as the economic recovery leads to expanded private credit. As yet, however, reliable estimates of the percentages of Treasury borrowing to total funds raised by nonfinancial sectors for 1984 are not available. The long-run goal of the Administration is to curb Federal spending and balance the budget, in which case, there would be no Federal borrowing required to finance budget deficits.

Questions Submitted by Senator Stennis

Q.

What is your view of the impact that this steadily growing and large debt will have on our economy?

A. The economic impact of the steadily growing Federal debt has shown up in the maintenance of high real interest rates. Investors have been wary of the potential inflationary impact of the huge Treasury financing requirements in prospect, not so much for the present, when a recession has been underway, but more importantly for the future, when the economy expands and private demands for credit grow. Large deficits in a recession are built into the system. As income growth slows spending down, tax receipts level off or fall and government spending for income growth picks up and recession needs fade, the deficits should narrow and Treasury financing demands recede, making room for the private financing entailed in renewed spending on plant and equipment, housing, and state and local government facilities. If the Treasury, as first in line among borrowers, preempts too much of the available funds, thus crowding out private borrowers, the effect is inflationary, unless economic growth is dampened again by monetary policy. With the deficits scheduled to remain high, investors foresee renewed inflation and rising interest rates, for which they demand a high inflation premium before tying up their investments.

Real interest rates (nominal rates less the inflation rate)are now running high enough to discourage some potential expansion, even as the economy is beginning to recover, and must decline for the recovery to be sustained. If the Federal Reserve keeps a rein on the money supply and the increases in the Federal debt decline, from a projected 21 percent in FY 1983 to 11 percent in FY 1986, real interest rates will come down, thus laying the groundwork for stable and noninflationary growth. The need for reducing the budget deficits by cutting spending through the President's program is clear.

Q.

Can we continue to pick up this debt at a faster rate than the GNP is growing?

A. The Federal debt has increased at a faster pace than GNP in six of the 17 fiscal years from 1966 to 1982. These six were all years affected by recession or slowdown and its aftermath, namely, 1968, 1971, 1975-76, 1980, and 1982. In all 11 of the other years, the pace of GNP growth has been faster than that in the Federal debt — especially so during years of strong economic growth. Beginning with FY 1983, however, the rate of expansion in the Federal debt is projected in the Budget to exceed that in GNP through FY 1986, as the relatively moderate GNP growth is accompanied by continued high deficits. Nevertheless, the gap will narrow substantially, from a 20.6 percent increase in the Federal debt in FY 1983 versus a 5.3 percent rise in GNP to a 10.9 percent rate of increase in the Federal debt in FY 1986 and an 8.9 percent rise in GNP. Such a trend is based on a sustainable noninflationary economic expansion of around

9 percent for GNP growth in the years 1983-86 and a diminution in the rate of Federal outlays from the 11-17 percent of the four fiscal years, 1980-83 to 7.7 percent in FY 1986.

Thus, the Administration proposes to curtail the recent tendency for the rate of growth in the Federal debt to exceed that in GNP. However, the curtailment will not be easy in the absence of a high inflation rate (which raises Federal receipts) and will thus take a longer time than in the past. A continuance of the recent trends would indeed pose serious economic problems, as Federal outlays, including burgeoning interest payments on the public debt, grow faster than receipts, entailing a repeat of the inflationary push that raised interest rates and inhibited economic expansion in the 1970s.

Q.
What impact will this large debt have on interest rates for the future?

A. A failure to follow the President's program of cutting spending and reducing the rate of growth in the Federal debt would surely lead to higher interest rates. Under the President's program, the rate of growth in the Federal debt is expected to gradually diminish, and the Federal Reserve is expected to maintain control over the money supply. With economic growth proceeding on a stable noninflationary path, as envisioned in the 1984 budget, real interest rates will fall, as investor requirements for an inflation premium decline. On the other hand, real interest rates would remain unduly high if investors looked ahead to a renewal of inflation. This would foster reluctance to save, which in turn, with higher Federal borrowing, would crowd private investors out of the credit markets and thereby feed into a lower rate of economic growth. Thus, continuation of the recent extreme excess of the rate of growth of the Federal debt over the rate of growth of GNP would lead to continued high interest rates and lower economic growth.

Q.
Can the government expect to finance this debt without setting off another round of inflation?

A. The increases in debt projected in the 1984 Budget will not necessarily be inflationary, provided the other features of the President's program are followed. Reductions in the rate of growth of budget outlays would be accompanied by lower tax rates, which provide inducements for saving and investing. In addition, control of the money supply by the Federal Reserve would prevent a recurrence of the recent inflationary bouts. As inflationary fears diminish, real interest rates would drop and thereby aid the maintenance of stable noninflationary economic growth and a declining trend in the rate of increase in the Federal debt. If the spending cuts are not made or the Federal Reserve loses control of the money supply, another round of inflation and higher interest rates is indeed likely.

Q. You say that the $75 billion trade deficit will depress domestic demand in the first year of recovery.

-- Do you think this trade deficit could put economic recovery at risk?

A. No. While our expected large trade deficit this year will of course be a drag on domestic recovery, it will be substantially outweighed by other, favorable, factors.

Q. You attribute this trade deficit to the high exchange value of the dollar.

-- Is this high exchange rate due to high U.S. interest rates?

-- Can the U.S. reduce this trade deficit without reducing U.S. interest rates?

-- Are there other steps such as import taxes or "buy American" provisions that would decrease imports and increase exports and help our economy?

A. Our trade position of course depends in part on relative growth rates and relative prices, here and abroad, as well as on exchange rates. With respect to the dollar exchange rate, high (or low) U.S. interest rates relative to major foreign countries are one among many factors which can at times be important in increasing (or reducing) the exchange value of the dollar. This has not recently been the dominant factor, as the dollar has remained strong or strengthened despite declining levels of U.S. interest rates and declining differentials between U.S. and foreign rates. Thus it is difficult to see any direct or certain connection between the level of U.S. interest rates and our trade deficit. Over time, the key to strengthening our trade position, as well as domestic growth, will be our success in stabilizing prices and increasing the productivity and competitiveness of the U.S. economy

Import taxes and "Buy American" provisions would not, except very briefly at most, reduce our trade deficit or contribute to our economic recovery. In a world of market-determined exchange rates, any resulting decrease in our total imports would, over time, work to strengthen the dollar exchange rate and thus, with a lag, reduce our exports also -- thereby, if anything, cutting back world trade volume in both directions and slowing rather than stimulating domestic growth rates both here and abroad. Such steps could also invite retaliation or emulation abroad, which would tend to shut off our own markets and be self-defeating in the end.

Questions Submitted by Senator Leahy

In response to my question about the size of the increase in the Defense Department budget, you presented a comparison of how much different parts of the budget were changing. You stated that Defense had increased from 26 percent to 34 percent and payments to individuals decreased from 48 percent to 46 percent (page 60 of the final report). Would you please supply the charts and figures upon which this statement is based.

RESPONSE

My statement (page 60 of the final report) is based on data that appear in the OMB report, Federal Finances -- February 1983, table 11, page 76. I have enclosed a copy of that page for your convenience.

Table 11.--COMPOSITION OF BUDGET OUTLAYS IN CURRENT PRICES: 1940-1988 (continued)

	1979	1980	1981	1982	1983	1984	Estimates 1985	1986	1987	1988
TOTAL BUDGET OUTLAYS.....	490,997	576,675	657,204	728,375	805,202	848,483	918,515	989,571	1,058,437	1,126,937
National defense.....	117,681	135,856	158,765	187,418	214,769	245,305	285,268	323,035	354,277	385,591
Nondefense:										
Payments for individuals.	227,495	271,104	316,591	348,603	391,892	401,016	425,491	443,556	463,820	517,900
All other grants.....	53,999	57,205	54,754	47,450	48,559	50,395	50,680	51,006	51,765	52,312
Net interest.....	42,606	52,458	68,726	84,697	88,926	103,180	114,210	122,692	130,415	134,264
All other.....	49,216	60,052	57,368	60,207	61,047	48,586	42,906	39,282	38,159	36,871
Total nondefense...	373,316	440,819	497,438	540,957	590,433	603,177	633,248	656,536	704,160	741,347
ADDENDUM										
Composition of payments for individuals:										
Direct:										
National defense.....	10,279	11,820	13,728	14,938	16,130	16,770	17,377	18,437	19,274	20,119
Nondefense.....	198,730	236,830	276,657	307,927	346,990	355,589	377,096	402,256	420,446	460,347
Indirect (grants-in-aid)	28,765	34,174	39,934	40,678	44,902	45,428	48,355	51,300	54,378	57,853
Total.....	237,774	283,824	330,320	363,541	408,022	417,787	442,827	471,893	503,084	538,318
Composition of grants to State and local governments:										
National defense.....	84	93	75	68	78	103	127	182	214	302
Nondefense.....	82,764	91,380	94,687	88,126	93,461	95,823	99,035	102,306	106,140	109,865
Total.....	82,858	91,473	94,762	88,194	93,537	95,926	99,162	102,488	106,354	110,168
Major physical capital investments:										
Direct Federal investments:										
National defense....	28,953	33,000	39,867	48,773	61,819	76,708	N/A	N/A	N/A	N/A
Nondefense.....	7,373	7,674	8,267	8,159	8,628	7,714	N/A	N/A	N/A	N/A
Subtotal.....	36,326	40,674	47,834	56,932	70,447	84,422	N/A	N/A	N/A	N/A
Grants to State and local governments for major physical investments.....	20,061	22,484	22,148	20,151	20,284	23,683	N/A	N/A	N/A	N/A
Total.....	56,387	63,158	69,982	77,083	90,730	108,105	N/A	N/A	N/A	N/A

N/A - not available

COMMITTEE RECESS

Senator CHILES. The chairman asked me to announce that the committee will reconvene tomorrow morning at 9:30 in the same room. At that time we will hear Dr. Rivlin and Dr. Feldstein.

Thank you.

Secretary REGAN. Thank you, Senator. Thank you for the courtesy.

[Whereupon, at 12 m., Tuesday, February 15, the hearing was recessed to reconvene at 9:30 a.m., Wednesday, February 16.]

ECONOMIC OVERVIEW FOR FISCAL YEAR 1984

WEDNESDAY, FEBRUARY 16, 1983

U.S. SENATE,
COMMITTEE ON APPROPRIATIONS,
Washington, D.C.

The committee met at 9:33 a.m. in room SD-192, Everett McKinley Dirksen Senate Office Building, Hon. Mark O. Hatfield (chairman) presiding.

Present: Senators Hatfield, McClure, Rudman, and Stennis.

EXECUTIVE OFFICE OF THE PRESIDENT

PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

STATEMENT OF DR. MARTIN FELDSTEIN, CHAIRMAN, PRESIDENT'S COUNCIL OF ECONOMIC ADVISORS

INTRODUCTION OF WITNESS

Chairman HATFIELD. The hearing will come to order.

This morning we have before us Dr. Martin Feldstein, Chairman of the President's Council of Economic Advisors and Dr. Alice Rivlin of the Congressional Budget Office.

I want to particularly apologize to Dr. Feldstein for the situation that we found ourselves in yesterday. Dr. Feldstein, you were extremely gracious and understanding in adjusting your schedule to come today. In fact, Dr. Feldstein was in his car on his way to the Hill when we reached him to postpone his testimony until today.

I believe you are the newest member of the team, having been confirmed last December. Dr. Feldstein came onboard with an excellent reputation for telling it like it is. I believe you already have some scars to show as a result of that style of communication. But I am delighted to welcome you on behalf of the ranking minority member, Senator Stennis, and myself and other members of the committee.

Dr. Feldstein, if you will proceed to summarize your testimony or as you wish, we will be delighted to hear from you.

CONGRESSIONAL CONTRIBUTIONS TO SOUND ECONOMIC POLICY

Mr. FELDSTEIN. Thank you very much, Mr. Chairman. I am certainly pleased to be here today. As you requested, I have focused these prepared remarks on the current economic outlook. I will comment

16-439 O - 83 - 6

briefly on the contribution that the Congress can make at this time to achieve a sound and sustained economic expansion.

Although there is good reason to be cautiously optimistic about the economy in 1983, I still think that the most accurate summary is that the outlook at this time is uncertain.

Such uncertainty, of course, is not unusual at a time when the economy is probably near the bottom of a recession. Moreover, as I will explain in a few moments, there are now special conditions in financial markets, in the international economy, and in projected budget deficits that add extra uncertainty at the present time.

ADMINISTRATION FORECAST

The administration's official forecast calls for real economic growth of 3.1 percent in 1983; that is, real GNP is forecast to rise 3.1 percent between the fourth quarter of 1982 and the fourth quarter of 1983.

I might just note that the real growth rate of 1.4 percent that some newspapers have used to describe the administration's forecast does not relate to growth in 1983 but compares the average level of income in 1983 with the average level in 1982.

For anyone interested in where the economy is going, the 3.1-percent growth rate is a more useful description.

FUTURE ECONOMIC FORECAST

After 1983 we, the administration, forecast annual growth of 4 percent a year through 1988. As I have emphasized elsewhere, our forecast is not an attempt to capture every likely up and down in future economic activity but to indicate the likely average growth over the next 6 years.

A more detailed discussion of the forecast and the approach to forecasting is presented in a separate appendix that I will submit for the record.

The forecast is not an optimistic statement of our aspirations or a pessimistic statement of our fears. It is, instead, a balancing of the probabilities of different outcomes. I believe that the forecast is balanced and cautious. It reduces the risk of unpleasant surprises but does so without being unduly pessimistic.

I must, however, stress the substantial uncertainty of the precise number. The forecast reflects judgments about three types of uncertainty: First, when will a sustained upturn begin; second, how long will the expansion be sustained; and third, how rapid will growth be during the upturn?

For example, if the recovery began last month, as many believe, if it is sustained long enough to qualify as an economic recovery, and if the rate of growth is similar to that in the first year of previous recoveries, we could see 5 percent real growth in 1983.

But if the recovery only begins in April or May, the growth this year could be less than 2 percent. The forecast of 3.1 percent is a balancing of the probabilities of such different possible outcomes.

LEADING INDICATORS IN ECONOMIC RECOVERY

Evidence has been accumulating for several months that a recovery was about to begin. The leading indicators have risen in 8 of the last 9 months. Interest rates fell sharply in the second half of 1982, and the real money balances grew significantly. The backlog of unfilled orders rose in December for the first time in more than a year. Most private forecasters have concluded from the evidence that 1983 will be a year of significant economic growth.

Many people believe that the long-awaited recovery has now begun. Only time will tell whether, in fact, the broad and sustained increase in economic activity that constitutes a recovery is already under way. When a recovery is under way, employment, sales, and industrial production will be rising steadily. It is important to bear in mind that the increases of such leading indicators as new orders, housing permits, and the real money stock are signals of likely future improvements in economic activity but are not evidence of improvements in current economic recovery.

It is, indeed, surprising that the leading indicators rose for so long without an upturn in general economic activity. The leading indicators started to rise 9 months ago. The usual lag between the rise of the leading indicators and the general economic upturn is only 3 or 4 months. If that lag had been in effect this time, economic recovery would have begun by the early fall of 1982.

The evidence shows clearly that economic activity was still falling in December. There were declines in industrial production, in sales, and in employment. The number of new domestic car sales was down 11 percent from November, and retail sales were down 1.1 percent. Although personal income, exclusive of transfer payments, rose $14 billion in December, almost 90 percent of the rise was due to a $12.3 billion increase in farm incomes that reflected yearend Government payments to farmers that were not properly adjusted for by the seasonal adjustment procedure.

STATISTICS ON UNEMPLOYMENT SITUATION

The only significant data on economic activity that were available when I wrote this testimony—there is a new piece of information I will mention in a minute—are the statistics on the employment situation. This evidence is encouraging, but it must be viewed with some caution.

The Department of Labor reported that the civilian unemployment rate for January was 10.4 percent, down from 10.8 percent in December.

In addition, nonfarm payroll employment, as measured by the monthly survey of establishments, rose by 340,000 between December and January, after seasonal adjustment. This represents the first fall in unemployment and the first significant rise in employment since the recession began. The rise in employment is important because it indicates a current increase in economic activity and not just a future one. If sustained, it may well be the first real sign of economic upturn.

It is, however, important not to place too much weight on a single month's statistics. Data for January are particularly difficult to interpret because the seasonal adjustment in January is large and often quite imperfect. The difficulty of seasonal adjustment for January reflects the importance of weather conditions in construction and other outdoor activities and the importance of post-Christmas layoffs in retail distribution. These sources of uncertainty appear to be particularly important this year.

The household survey that reported a seasonally adjusted decline of nearly 600,000 in the number of unemployed showed almost no increase in the number of employed. Indeed, employment of men aged 20 and over actually declined, according to the household survey. These estimates are surprising since employment generally rises in recoveries before the unemployment rate begins to decline.

One clue to the puzzle is that some of the decline in unemployment reflects fewer people becoming unemployed rather than more of the previously unemployed people getting jobs. This could be an artifact of the seasonal adjustment process. If this year retailers hired fewer extra Christmas employees than usual, there would be fewer layoffs after Christmas; the reduced number of layoffs could appear as a lower level of January unemployment even though in reality it only reflected less hiring the month before.

EMPLOYMENT INCREASES

The evidence of a significant increase in employment comes from the establishment survey of employees on nonagricultural payrolls. Although this reported increase of 340,000 additional payroll employees contrasts with the absence of increased employment in the household survey, the establishment survey is frequently regarded to be more accurate and certainly deserves careful consideration. Nevertheless, an analysis of the detailed employment figures shows that the increase in employment was concentrated in construction and in retail trade, the two industry groups most likely to be affected by seasonal adjustment problems.

In construction, year-to-year differences in weather make accurate seasonal adjustment difficult; I have already discussed the problems of adjusting retail trade figures. As an indication of the magnitude of the problem, I might note that while the seasonally adjusted measure of employment in construction rose 3 percent, the corresponding measure of nonseasonally adjusted employment fell nearly 7 percent.

Similarly, seasonally adjusted retail trade employment rose 1.6 percent while the corresponding unadjusted employment fell 3.6 percent. In both cases, relatively small errors in seasonal adjustment could cause substantial distortion.

I don't want to appear to be too skeptical about the favorable employment data. They do show that the decline in manufacturing employment has appeared to stop—at least temporarily—and that employment has actually increased in a majority of the 186 individual industries. But it is important to examine very carefully the data that will be released in early March to see just what is happening to employment.

STATISTICS ON INDUSTRIAL PRODUCTION

There is one new statistic that I might mention that just became available this morning, and that is on industrial production. Industrial production figures for January are now reported to be up 0.9 percent. That is only the second time since the recession began that we have had a significant increase in industrial production. So I regard that as favorable news and it reinforces the news on the employment front.

Again, one small caution on that. The industrial production figures are primarily at this point a reflection of what is happening to average working hours per week and therefore they have to be understood as a reflection of the survey information on labor inputs rather than being primarily a measure of actual output.

FINANCIAL MARKETS AND INTERNATIONAL ECONOMY

Let me turn now to the special problems of financial markets and the international economy.

It is widely recognized that appropriate monetary conditions are a prerequisite for our economic recovery. It is encouraging therefore that interest rates have fallen sharply since mid-1982 and that the real money stock in 1982 has increased about 5 percent—while the real money stock showed virtually no growth in 1981. There are, however, serious problems in interpreting these monetary changes.

DECLINE IN INTEREST RATES

Consider first the fall in interest rates. Calculating the real rate of interest requires subtracting expected inflation from the market interest rate. A business firm might calculate a real rate of interest by comparing the interest rate on commercial paper with the average rate of increase of the prices of its own products during the previous year. If we approximate this by comparing the commercial paper rate and the previous increase in the GNP deflator, we see that there has been very little change in the real interest rate since a year ago.

In January 1982, the commercial paper rate was 13.4 percent and the GNP deflator had risen to 8.9 percent. Thus the real rate of interest calculated in this way was 4.5 percent. A year later, in January 1983, the commercial paper rate was down to 8.2, but the GNP deflator had risen only 4.6 percent, implying a real inflation rate of 3.6. Thus the real rate declined by less than 1 percent.

A more appropriate measure of the cost of debt funds is the real net-of-tax interest rate. A year ago, a corporate borrower with a 46-percent marginal tax rate that paid 13.4 percent for commercial paper had an after-tax cost of funds of 7.2 percent. Subtracting the 8.9-percent rate of GNP inflation left a real net-of-tax cost of funds of only -1.7 percent. Today, the 8.2-percent commercial paper rate corresponds to an after tax cost of 4.4 percent and a real after tax cost of -0.2 percent. Thus the real net-of-tax cost of funds has actually risen since a year ago from -1.7 percent to -0.2 percent.

In addition, by any of a variety of measures, real interest rates are now substantially higher than in the sixties and seventies. For example,

back in 1971 and 1972 when the GNP deflator was last increasing in the range of 4 to 5 percent, the commercial paper rate was about 5 percent or some 3 percentage points below the current rate. The difference in long-term rates is even greater.

HIGH REAL INTEREST COSTS

It is not unreasonable to worry that such high real interest costs will block the recovery, diminish its strength, or cause it to end prematurely. Balanced against this are three countervailing considerations.

First, the stock market has increased about 25 percent over the past 12 months, implying a substantial reduction in the real cost of equity funds to firms. The lower cost of equity funds encourages investment even if the real interest cost is high.

Second, the changes in tax depreciation rates enacted in 1981 and 1982 and the substantial reduction in inflation have both caused an increase in the real after-tax profitability of investment in plant and equipment. This greater profitability may outweigh the higher cost of funds and thereby spur more investment.

Finally, to the extent that the high real interest rate is itself the result of noninvestment borrowing and spending, the lower level of investment represents a shift of demand and not necessarily a reduction of total demand.

REAL MONEY STOCK

The 5-percent growth in the real money stock in 1982, and the previous projection that M2 in 1983 will grow in the upper half of the 6- to 9-percent range, are consistent with nominal GNP growth of 8 to 10 percent and real GNP growth of about 3 to 4 percent in 1983 if the historic relation of a constant rate of M2 to nominal GNP continues in 1983. However, this historically constant velocity changed abruptly in 1982, falling some 6 percent.

Moreover, the major changes in financial regulation that took effect in December 1982 to January 1983 are now causing a shift of assets that makes it temporarily impossible to assess the growth of the shift-adjusted money stock. In short, at the present moment, the traditional rules linking money growth and the growth of the economy are temporarily in abeyance.

None of this is meant to suggest that monetary conditions and the state of the financial market preclude a healthy recovery in 1983. But they do create sufficient uncertainty that caution must be exercised in making the economic forecast and associated budget calculations.

EFFECT ON ECONOMY OF INTERNATIONAL ECONOMIC CONDITIONS

International economic conditions will have a profound and unusual effect on this year's economic recovery. For a variety of reasons, U.S. exports to the rest of the world will fall in 1983 while our imports from the rest of the world will increase.

International trade experts now say that the difference between merchandise exports and merchandise imports—known as the net merchandise trade balance—is likely to show a deficit this year of about $75 bil-

lion, more than twice the 1982 trade deficit and nearly three times the 1981 deficit.

TRADE DEFICITS

A $75 billion trade deficit means that $75 billion of final demand is directed to overseas markets instead of to our own domestic economy. The sharp increase in this trade deficit depresses domestic demand to a much greater extent than ever before in the first year of a recovery.

The principal reason for this trade deficit is the high exchange value of the dollar vis-a-vis other currencies. During the past 2 years, the real value of the dollar has increased by about one-third relative to the value of other major currencies. This raises the relative price of our exports and makes imports from abroad more competitive in the U.S. market.

A second reason for the large trade deficit in 1983 is the depressed state of demand in the other major countries of the world. The major countries of Europe expect little or no real growth this year and several of them are hoping to increase their own net exports to the rest of the world. The debtor nations among the developing countries—Mexico, Brazil, Argentina, and several others—will be trying hard in 1983 to reduce their imports and increase their exports. This will reduce the demand for the output of the United States and of other industrial nations.

INTERNATIONAL DEBT SITUATION

The seriousness of the international debt situation may have other adverse consequences on the recovery. At a minimum, American banks with large illiquid loan portfolios may restrict domestic lending and accumulate larger reserves during the coming year.

The banks' need to channel substantial additional resources into increasing their foreign loans will also alter the character of bank lending in the United States.

BUDGET DEFICIT

Until now, I have been talking about the economic outlook without referring directly to the budget deficit. I say directly because many of the problems to which I have referred are in fact due in whole or in part to the large budget deficits that face us in the second half of this decade if appropriate legislative action is not taken. These large potential outyear deficits raise real interest rates and, by doing so, strengthen the dollar relative to foreign currencies.

The problems that will be faced in 1983 by the construction and capital goods industries and by the export and import-competing industries can be traced to the prospects of large deficits in 1985 and beyond.

The best thing that the Congress can do at the present time is to move speedily to the adoption of the fiscal year 1984 budget and the specific changes that will reduce the deficits in later years.

The administration's budget proposals eliminate about two-thirds of the structural deficit in 1988 and limit the deficit in that year to about 2

percent of GNP. A few further years in which the growth of real Government spending is slowed can cause the deficit to shrink further until a balanced budget is achieved.

This morning I have tried to emphasize that there is a good basis for cautious optimism about a recovery this year. Indeed, recent evidence indicates that a recovery has begun or will soon begin.

The next few months will show whether we do indeed have a continuing upturn in production, employment, and sales. Now Congress must join with the administration to shape the budget in a way that rebuilds confidence and contributes to a sound and sustainable recovery.

Thank you, Mr. Chairman.

[The statement follows:]

PREPARED STATEMENT OF MARTIN FELDSTEIN
CHAIRMAN
COUNCIL OF ECONOMIC ADVISERS

THE CURRENT ECONOMIC OUTLOOK

Thank you, Mr. Chairman. I am very pleased to appear before this distinguished committee today. As you requested, I will focus my prepared remarks on the current economic outlook. I will then comment briefly on the contribution that the Congress can make at this time to achieving a sound and sustained economic expansion.

The Administration Forecast

Although there is good reason to be cautiously optimistic about the economy in 1983, the most accurate summary is that the outlook at this time is still "uncertain". Such uncertainty is not unusual at a time when the economy is probably near the bottom of a recession. Moreover, as I will explain after a few minutes, there are now special conditions in financial markets, in the international economy and in projected budget deficits that add extra uncertainty at the present time.

The Administration's official forecast calls for real economic growth of 3.1 percent in 1983; that is, real GNP is forecast to rise 3.1 percent between the fourth quarter of 1982 and the fourth quarter of 1983. (I might just note that the real growth rate of 1.4 percent that some newspapers have used to describe the Administration's forecast does not relate to growth in 1983 but compares the average level of income in 1983 with the average level in 1982. For anyone interested in where the economy is going, the 3.1 percent growth rate is a more useful description.)

After 1983 we forecast annual growth of 4 percent a year through 1988. As I have emphasized elsewhere, our forecast is not an attempt to capture every likely up and down in future economic activity but to indicate the likely average growth over the next six years. A more detailed discussion of the forecast and of our approach to forecasting is discussed in the appendix to this testimony.

The forecast is not an optimistic statement of our aspirations or a pessimistic statement of our fears. It is instead a balancing of the probabilities of different outcomes. I believe that the forecast is balanced and cautious. It reduces the risk of unpleasant surprises without being unduly pessimistic.

I must, however, stress the substantial uncertainty of the precise number. The forecast reflects judgements about three types of uncertainty: when will a sustained upturn begin; how long will the expansion be sustained; and how rapid will growth be during the upturn. For example, <u>if</u> the recovery began last month, <u>if</u> it is sustained long enough to qualify as an economic recovery, and <u>if</u> the rate of growth is similar to that in the first year of previous recoveries, we could see five percent real growth in 1983. But if the recovery only begins in April or May, the growth this year could be less than two percent. The forecast of 3.1 percent is a balancing of the probabilities of such different possible outcomes.

Evidence has been accumulating for several months that a recovery was about to begin. The leading indicators have risen in eight of the last nine months. Interest rates fell sharply in the second half of 1982 and real money balances grew significantly. Housing starts rose above the depressed levels of 1981. The backlog of unfilled orders rose in December for the first time in more than a year. Most private forecasters have concluded from the evidence that 1983 will be a year of significant economic growth. Many people believe that the long-awaited recovery has now begun.

Only time will tell whether in fact the broad and sustained increase in economic activity that constitutes a recovery is already under way. When a recovery is under way, employment, sales and industrial production will be rising steadily. It is important to bear in mind that the increases in such leading indicators as new orders, housing permits, and the real money stock are signals of likely future improvements in economic activity but are not evidence of improvements in current economic recovery.

It is indeed surprising that the leading indicators rose for so long without an upturn in general economic activity. The leading indicators started to rise nine months ago. The usual lag between the rise in the leading indicators and the general economic upturn is only three or four months. If that lag had been in effect this time, economic recovery would have begun by the early fall of 1982.

The evidence shows clearly that economic activity was still falling in December. There were declines in industrial production, in sales and in employment. The number of new domestic car sales was down 11 percent from November and retail sales in general were down 1.1 percent. Although real personal income exclusive of transfer payments rose $14.0 billion in December, almost 90 percent of the rise was due to a $12.3 billion rise in farm incomes that reflected year end government payments to farmers that were not properly adjusted for by the seasoned adjustment procedure.

The only significant data on economic activity in January that are now available are the statistics on the employment situation. This evidence is encouraging but must be viewed with caution. The Department of Labor reported that the civilian unemployment rate for January was 10.4 percent, down from 10.8 percent in December. In addition, nonfarm payroll employment -- as measured by the monthly survey of establishments -- rose by 340,000 between December and January,

after seasonal adjustment. This represents the first fall in unemployment and the first significant rise in employment since the recession began. The rise in employment is important because it indicates a current increase in economic activity and not just a future one. If sustained, it may well be the first sign of an economic upturn.

It is, however, important not to place too much weight on a single month's statistics. Data for January are particularly difficult to interpret because the seasonal adjustment in January is large and often quite imperfect. The difficulty of seasonal adjustment for January reflects the importance of weather conditions in construction and other outdoor activities and the importance of post-Christmas layoffs in retail distribution. These sources of uncertainty appear to be particularly important this year.

The household survey that reported a seasonally adjusted decline of nearly 600,000 in the number of unemployed showed almost no increase in the number of employed. Indeed, employment of men aged 20 and over actually declined. These estimates are surprising since employment generally rises in recoveries before the unemployment rate begins to decline. One clue to the puzzle is that most of the decline in unemployment reflects fewer people becoming unemployed rather than more of the previously unemployed people getting jobs. This could be an artifact of the seasonal adjustment process. If this year retailers hired fewer extra Christmas employees than usual, there would be fewer layoffs after Christmas; the reduced number of layoffs could appear as a lower level of January unemployment even though in reality it only reflected less hiring the month before.

The evidence of a significant increase in employment comes from the establishment survey of employees on nonagricultural payrolls. Although this reported increase of 340,000 additional payroll employees contrasts with the absence of

increased employment in the household survey, the establishment survey is frequently regarded to be more accurate and certainly deserves careful consideration. Nevertheless, an analysis of the detailed employment figures shows that the increase in employment was concentrated in construction and in retail trade, the two industry groups most likely to be affected by seasonal adjustment problems. In construction, year-to-year differences in weather make accurate seasonal adjustment difficult; I have already discussed the problems of adjusting retail trade figures. As an indication of the magnitude of the problem, I might note that while the seasonally adjusted measure of employment in construction rose three percent, the corresponding measure of not seasonally adjusted employment fell nearly 7 percent. Similarly, seasonally adjusted retail trade employment rose 1.6 percent while the corresponding unadjusted employment fell 3.6 percent. In both cases, relatively small errors in seasonal adjustment could cause substantial distortion.

I don't want to appear to be too skeptical about the favorable employment data. They do show that the decline in manufacturing employment has appeared to stop (at least temporarily) and that employment has actually increased in a majority of the 86 individual industries. But it is important to examine very carefully the data that will be released in early March to see just what is happening to employment.

Monetary Conditions and Financial Markets

It is widely recognized that appropriate monetary conditions are a prerequisite for our economic recovery. It is encouraging therefore that interest rates have fallen sharply since mid-1982 and that the real money stock in 1982 has increased about 5 percent (while the real money stock showed virtually no growth in 1981). There are, however, serious problems in interpreting these monetary changes.

Consider first the fall in interest rates. Calculating the real rate of interest requires subtracting expected inflation from the market interest rate. A business firm might calculate a real rate of interest by comparing the interest rate on commercial paper with the average rate of increase of the prices of its own products during the past year. If we approximate this by comparing the commerical paper rate and the previous increase in the GNP deflator, we see that there has been very little change in the real interest rate since a year ago. In January 1982, the commercial paper rate was 13.4 percent and the GNP deflator had risen at 8.9 percent. Thus the real rate of interest calculated in this way was 4.5 percent. In January 1983, the commercial paper rate was down to 8.2 but the GNP deflator had risen only 4.6 percent, implying a real inflation rate of 3.6. Thus the real rate declined by less than one percent.

A more appropriate measure of the cost of debt funds is the real net-of-tax interest rate. A year ago, a corporate borrower with a 46 percent marginal tax rate that paid 13.4 percent for commercial paper had an after-tax cost of funds of 7.2 percent. Subtracting the 8.9 percent rate of GNP inflation left a real net-of-tax cost of funds of only -1.7 percent. Today, the 8.2 percent commercial paper rate corresponds to an after tax cost of 4.4 percent and a real after tax cost of -0.2 percent. Thus the real net-of-tax cost of funds has actually risen since a year ago from -1.7 percent to -0.2 percent.

In addition, by any of a variety of measures, real interest rates are now substantially higher than in the 1960s and 1970s. For example, back in 1971 and 1972 when the GNP deflator was last increasing in the range of four to five percent, the commercial paper rate was about five percent or some three percentage points below the current rate. The difference in long-term rates is even greater.

It is not unreasonable to worry that such high real

interest costs will block the recovery, diminish its strength, or cause it to end prematurely. Balanced against this are three countervailing considerations. First, the stock market has increased about 25 percent over the past 12 months, implying a substantial reduction in the real cost of equity funds to firms. The lower cost of equity funds encourages investment even if the real interest cost is high. Second, the changes in tax depreciation rates enacted in 1981 and 1982 and the substantial reduction in inflation have both caused an increase in the real after-tax profitability of investment in plant and equipment. This greater profitability may outweigh the higher cost of funds and thereby spur more investment. Finally, to the extent that the high real interest rate is itself the result of noninvestment borrowing and spending, the lower level of investment represents a shift of demand and not necessarily a reduction of total demand.

The 5 percent growth in the real money stock in 1982, and the previous projection that M2 in 1983 will grow in the upper half of the 6 to 9 percent range, are consistent with nominal GNP growth of 8 to 10 percent and real GNP growth of about 3 to 4 percent in 1983 if the historic relation of a constant rate of M2 to nominal GNP continues in 1983. However, this historically constant velocity changed abruptly in 1982, falling some six percent. Moreover, the major changes in financial regulation that took effect in December 1982 and January 1983 are now causing a shift of assets that makes it temporarily impossible to assess the growth of the shift-adjusted money stock. In short, at the present moment,the traditional rules linking money growth and the growth of the economy are temporarily in abeyance.

None of this is meant to suggest that monetary conditions and the state of the financial market preclude a healthy recovery in 1983. But they do create sufficient uncertainty that caution must be exercised in making the economic forecast and associated budget calculations.

International Conditions

International economic conditions will have a profound and unusual effect on this year's economic recovery. For a variety of reasons, U.S. exports to the rest of the world will fall in 1983 while our imports from the rest of the world will increase. International trade experts now say that the difference between merchandise exports and merchandise imports -- known as the net merchandise trade balance -- is likely to show a deficit this year of about $75 billion, more than twice the 1982 trade deficit and nearly three times the 1981 deficit. A $75 billion trade deficit means that $75 billion of final demand is directed to overseas markets instead of to our domestic economy. The sharp increase in this trade deficit depresses domestic demand to a much greater extent than ever before in the first year of a recovery.

A principal reason for this trade deficit is the high exchange value of the dollar vis-a-vis other currencies. During the past two years, the real value of the dollar has increased by about one-third relative to the value of other major currencies. This raises the relative price of our exports and makes imports from abroad more competitive in the U.S. market.

A second reason for the large trade deficit in 1983 is the depressed state of demand in the other major countries of the world. The major countries of Europe expect little or no real growth this year and several of them are hoping to increase their own net exports to the rest of the world. The debtor nations among the developing countries -- Mexico, Brazil, Argentina and several others -- will be trying hard in 1983 to reduce their imports and increase their exports. This will reduce the demand for the output of the United States and other industrial nations.

The seriousness of the international debt situation may have other adverse consequences on the recovery. At a minimum,

American banks with large illiquid loan portfolios may restrict domestic lending and accumulate larger reserves during the coming year. The banks' need to channel substantial additional resources into increasing their foreign loans will also alter the character of bank lending in the United States.

The Budget Deficit

I have until now been talking about the economic outlook without referring directly to the budget deficit. I say "directly" because many of the problems to which I have referred are in fact due in whole or in part to the large budget deficits that face us in the second half of this decade if appropriate legislative action is not taken. These large potential out-year deficits raise real interest rates and, by doing so, strengthen the dollar relative to foreign currencies. The problems that will be faced in 1983 by the construction and capital goods industries and by the export and import-competing industries can be traced to the prospects of large deficits in 1985 and beyond.

The best thing that the Congress can do at the present time is to move speedily to the adoption of the fiscal year 1984 budget and the specific changes that will reduce the deficits in later years. The Administration's budget proposals eliminate about two-thirds of the structural deficit in 1988 and limit the deficit in that year to about two percent of GNP. A few further years in which the growth of real government spending is slowed can cause the deficit to shrink further until a balanced budget is achieved.

Conclusion

Today I have tried to emphasize that there is a good basis for cautious optimism about a recovery in 1983. Recent evidence indicates that a recovery has begun or will soon begin. The next few months will show whether we do indeed have

a continuing upturn in production, employment and sales. Now Congress must join with the Administration to shape the budget in a way that rebuilds confidence and that contributes to a sound and sustainable recovery.

Appendix

The Economic Forecast*

In early January 1983, when the Administration's economic forecast was completed, there was no clear evidence that an economic recovery had begun. The most recent available monthly evidence on production, employment and the real volume of sales continued to show declines. Preliminary information indicated that real GNP had declined significantly in the final quarter of 1982. The economic statistics that have become available in the past few weeks confirm that December was a month of declining economic activity.

We nevertheless believed in early January that the economy would soon turn around and that the recovery was likely to begin sometime in the first half of 1983, most probably in the first quarter of the year. As of early January, the index of leading indicators had increased in seven of the previous eight months for which figures were then available. The most recent increase reflected favorable signs in labor, product and financial markets. We reflected our belief in an early recovery by forecasting a positive first quarter with GNP rising at an annual rate of 1.0 percent.

The December data that have become available since the forecast was completed provide further support for the conclusion that a recovery will soon be under way. The Index of Leading Indicators for December rose 1.5 percent, the largest increase in more than two years. This rise in the index reflected an increase in new orders, a decline in new claims for unemployment insurance, an increase in building

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* This appendix was previously presented as testimony to the Joint Economic Committee, February 2, 1983.

permits, and other favorable signs of an impending recovery.

The actual rate of growth in the first quarter of 1983 will depend on just when the recovery begins. If we eventually learn that December 1982 was the trough of the recession, the rate of growth in the first quarter of 1983 is likely to be significantly greater than one percent. But if the recovery does not begin until March, the rate of growth for the quarter as a whole could well be negative. The appropriate forecast for the first quarter of 1983 requires balancing the probabilities of alternative starting dates for the recovery.

If the recovery does begin in the first quarter of 1983, the rate of growth is likely to increase as the year progresses. It is possible that there could be some quarters of extremely rapid growth. The precise quarterly pattern is however very difficult to predict, especially since the date of the cycle trough is still unknown.

The rate of economic growth in 1983 as a whole depends critically on just when the recovery begins. Our forecast of a 3.1 percent increase in real GNP between the fourth quarter of 1982 and the fourth quarter of 1983 reflects a balancing of probabilities of the different possible outcomes. If the recession reached bottom in December and the level of economic activity rises in January, the rate of real growth for the year as a whole could be significantly greater than three percent. If the recovery begins in January, I would not be at all surprised to see five percent real GNP growth in 1983. But if the start of the recovery is delayed until April and May, the real growth in 1983 could be less than two percent.

At the present time, it is best to avoid the optimistic or pessimistic extremes and to use a forecast that represents a balance of probabilities. I believe that our forecast of 3.1 percent growth in 1983 is a cautious and prudent estimate that reduces the risks of unpleasant surprises without being unduly pessimistic.

All forecasts are inherently uncertain. The extent to which the uncertainty of a forecast impairs its usefulness depends on the purpose for which the forecast is intended. A business that wants to use an economic forecast to plan its near-term production and inventories would need a forecast that provides quite accurate short-term detail. A government that is trying to adjust monetary and fiscal policies continuously to prevent any unwanted fluctuations in real GNP would also need more accurate forecasts than we believe are possible. The primary purpose of the Administration's economic forecast, however, is to serve as a basis for long-term budget planning.

It is significant, therefore, that the current forecast was prepared in conjunction with planning the budget for fiscal years 1984 through 1988. The budget for fiscal year 1983 was completed last year and is no longer a subject for decision making. From a budgetary point of view, 1983 is relevant only because the rate of growth in 1983 influences the starting level of income in 1984. The specific quarterly pattern of changes in income and prices in fiscal year 1983 is therefore irrelevant since only their cumulative effect influences the outlook for fiscal year 1984.

Indeed, the primary attention on the forecast should be focussed on the longer term outlook through 1988. I understand fully the difficulty of making such a forecast and the uncertainties that are associated with it. But a conscientious long-term forecast is better than no forecast at all. An analysis of the likely future path of the economy is the only way to reduce the risk of unpleasant surprises and to have a quantitative framework for long-term policy changes. This is particularly important now when such a large portion of Federal government outlays can only be changed slowly and as part of a long-term process.

Our strategy in making this longer term forecast is to focus on the overall trend in real GNP and not to attempt to

forecast year to year fluctuations. We forecast a four percent rate of growth of real GNP in 1984 through 1988. We recognize that there will be some years in which real growth exceeds four percent and others in which it is less than four percent. But we don't pretend to have the ability to forecast these year to year oscillations. I would emphasize again that such detail is unnecessary for the purpose of shaping the budget and guiding the evolution of government programs. If economic activity exceeds our projection in some future year, the budget defict will be smaller that we forecast; conversely, if the economy is weaker than our projection in some future year, the deficit will be larger. Such cyclical fluctuations in the deficit along a path toward budget balance are not inappropriate.

The increase in real GNP that we forecast implies that employment will rise by more than two million persons between the first quarter of this year and the first quarter of 1984 and that the economy will employ 14 million more people in 1988 than it does today. The resulting unemployment rate would be about 6.5 percent.

Forecasting inflation is certainly no easier than forecasting real GNP. Over the next six years, the price level will be subject to unpredictable shifts caused by events peculiar to the agricultural markets and the markets for raw materials. However, the basic path of inflation will depend on the monetary policy pursued by the Federal Reserve. Our forecast assumes that the Federal Reserve will continue to pursue a policy that is consistent with a gradual decline in inflation and we make no attempt to allow for transitory price shocks after 1983. In the near term, we assume that an end to the sharp decline in agricultural prices and a possible decline in the exchange value of the dollar will cause the GNP deflator to rise 5.6 percent between the fourth quarter of 1982 and the

fourth quarter of 1983. After that we forecast a gradual decline in inflation to a rate of 4.4 percent in 1988.

In short, our forecast calls for a long-lasting recovery and economic growth with declining inflation. It is important to have a sound recovery that can be sustained. Of the five recoveries in the past quarter century, only two lasted more than four years. The recovery that began in July of 1980 lasted only a year. The recoveries of 1958 and 1970 lasted only two and three years respectively.

Our forecast of an expansion that continues without interruption for six years is therefore quite ambitious. The expectation that real growth will average 4 percent a year over the next six years is however both realistic and prudent. The average annual rate of increase in real GNP during the six years after the troughs of the seven postwar recessions was 4.2 percent. Despite the low level of the economy today, our growth forecast is very much in the middle of the postwar experience. Our forecast is, however, ambitious in predicting a sustained expansion without increasing inflation. The two long-lasting expansions of the postwar period were accompanied by increasing inflation. When the 1961 recovery began, inflation was under one percent; by the time that the expansion reached its peak in 1969, the inflation rate had increased to more than six percent. The expansion in the second half of the 1970s saw inflation rise from less than five percent in 1976 to more than 13 percent in 1979.

A balanced recovery that permits sustained expansion without increasing inflation will not happen automatically. It requires a sound monetary policy and budgetary changes that shrink the government deficits significantly during the years ahead. I believe that the Federal Reserve appreciates the importance of pursuing a sound monetary policy and that the budget that the President submitted on January 31st indicates the budget savings that are necessary for a healthy recovery.

REDUCTIONS OF DEFICIT

Chairman HATFIELD. Dr. Feldstein, you have lived up to your reputation of being a very frank and forthright person. Your testimony has certainly reflected your frankness this morning. I don't interpret it as being either a statement of pessimism or of Pollyanna optimism, but a very realistic statement.

I would like to ask you a question relating to deficits. The administration's game plan is to try to reduce from a $194 billion deficit to $117 billion by 1988. Recognizing that there are different ways to reduce the deficit, there are other game plans that are beginning to emerge offered by people outside of Government with recognized expertise. Also, a group of us in the Senate has been meeting. We foresee the possibility of having a deficit by 1988 of far less than $117 billion, by taking certain actions in 1984 and 1985.

Do you foresee a significant reduction of those deficits as having a salutary impact on this economic recovery, especially specific actions, not just theorizing, but an actual commitment in the Congress and with, hopefully, the support of the administration?

I am not talking about only military reduction, but many other reductions as well, including controls on some 77 programs that have greatly escalated, and perhaps even dealing with some of the revenue side of the problem.

Obviously, revenue has an important bearing on deficits, as well as spending.

I am not asking you to endorse any specific programs, but just the idea of some way to more substantially reduce the outyear deficits. What kind of impact would that have, both in the short term and in the long term, as you see it, on the economic recovery?

Mr. FELDSTEIN. There is no question that reducing the outyear deficits in a way that commits the Congress to outyear reductions, and entails lower outlays or greater revenue in the future, is critical to the recovery. I think that the only way we can see long-term interest rates come down, both real interest rates and the inflation premium that keeps nominal rates high, is to bring down those outyear deficits.

The comparison between $197 billion now and $117 billion later may understate just how large the reduction is implied by the administration's program because the current deficits are about 6½ percent of GNP.

The $117 billion in 1988 is only 2.4 percent of GNP. So it is a very substantial shrinking of the deficit. Indeed, of the structural deficit that would otherwise prevail in 1988, it is an elimination of about two-thirds, bringing it down from about $300 billion, which it would be in the current services budget, to about $117 billion.

SERVICING OF DEFICIT

Chairman HATFIELD. Of course, we recognize, too, that we are increasing the burden on our back of carrying an ever increasing accumulative debt and the servicing of that debt.

You know by this time I had hoped we could begin to try to reduce the accumulated debt rather than still struggling to bring the current annual deficit down.

Mr. FELDSTEIN. Well, that is absolutely right. I mean, the magnitude of the debt is such that the interest costs of servicing that debt are becoming a very significant factor.

In 1980, they were about 2.1 percent of GNP, the current services budget. Then we get up to 3.4 percent of GNP in 1988, but the administration's deficit reduction plan between now and 1988, the reduction in interest alone in 1988, will be about seven-tenths of 1 percent of GNP for about $130 million in that year alone.

It is very important to get the savings in the near term as well as in the longer term.

TAX COLLECTIONS

Chairman HATFIELD. There are so many factors involved here. Going back to the revenue part of this puzzle, I have heard that if we collected all the taxes due, we would certainly have quite a different deficit; we would be looking at accumulative figures far better than we are now.

But be that as it may, let me turn to the question of interest rates. You may have heard Mr. Iacocca and other people from industry say that in effect, we have to see a 2-percent drop in interest rates from the prime of 11 to possibly 9.

Do you see that as a possibility?

Second, how do we get the bankers to scale consumer loans more closely to the prime interest rate?

You have alluded to the problem in the international picture, the impact of these soft loans and problem loans to Brazil, and to Mexico, but let's take a banker out there in Oklahoma or Oregon dealing with a homebuilder or some other consumer.

Some of those interest rates are still 14, 15, or 16 percent to the average American citizen, and yet the prime is down to 11 percent.

So that is a two-part question.

Is it possible to get the prime from 11 to 9, and, number 2, how do we get consumer loans closer to the prime interest rate that is being charged by the banks?

Mr. FELDSTEIN. I put less emphasis, in my own thinking, on the prime itself. The prime used to be a good indicator of the best lending rates the banks offered. Other rates were geared up from there, but I think now the prime has taken on an almost symbolic rather than real meaning, and virtually all of the customers who would once have been classified as prime are now capable of borrowing not just in financial markets, but from the banks at better than prime rates.

So while there is a symbolic value in the prime, I tend to look at the market interest rates themselves. We see that the commercial paper rate is now down between the 8- and 9-percent range.

I think that gives a better sense of what the prime borrowers are borrowing at. There is of course a usual spread that reflects carrying costs, risks, and the service costs for different classes of borrowers.

I think our basic question is, how can we get all of these rates to come down? That primarily relates to the issue of the deficit.

I think that the Federal Reserve is not in a position now where it can actively bring down rates by providing more money to the system; any attempt to do that runs the risk of having just the opposite effect.

Chairman HATFIELD. Are you saying that the President's economic game plan that we are discussing will not bring rates lower than they are now?

Mr. FELDSTEIN. No. No; I am not saying that. I am saying that if Congress were somehow to pass a budget tomorrow that committed revenues and outlays in such a way over the next 5 years that financial investors could look and see a deficit of 2 percent rather than 6 percent of GNP out in 1988, we would see an immediate fall in long-term interest rates and, indeed, the whole structure of interest rates.

Chairman HATFIELD. So you are saying that the economic game plan will trigger a further reduction of prime interest rates?

Mr. FELDSTEIN. It will if, in fact, it gets enacted and provides that kind of reassurance.

REDUCTION OF SPENDING PROGRAMS

Chairman HATFIELD. Since no Congress can bind a future Congress, how are we going to guarantee reductions in spending programs; control the entitlement programs; adjust the revenue side and all these other factors so that we know we will only have a $117 billion deficit by 1988?

Mr. FELDSTEIN. Of course, you are right that a future Congress could decide to spend more and to cut taxes further. That would enlarge the deficits, but that, at this stage, is still a hypothetical problem of people imposing more of a problem on the financial markets.

The real problem that the financial markets face now is that unless there is action, we will have these very large deficits. There is no doubt in my mind that if Congress enacts a budget like the administration's budget that does provide for substantial increases in revenue and does enable structural changes that call for significant declines in spending that we will have a smaller deficit.

Chairman HATFIELD. If we stick to the 1984 program as outlined by the President, you foresee that as sufficient commitment by the Congress and the White House to bring interest rates down?

Mr. FELDSTEIN. I do.

Chairman HATFIELD. 2 percent?

Mr. FELDSTEIN. Too hard to say.

Chairman HATFIELD. 1½ percent?

Mr. FELDSTEIN. I don't want to guess. [Laughter.]

I think it is fair to say that interest rates are several percentage points, three, maybe more, higher in real terms now than they have been historically and that the deficit in this country is a major contributor to that.

It is not the sole cause of it, and, therefore, you wouldn't necessarily expect real interest rates to return to their historic levels simply by bringing the deficit back in line.

EFFECT OF PROJECTED DEFICIT REDUCTION ON INTEREST RATES

Chairman HATFIELD. Does it follow, then, that if the Congress takes additional action through a combination of thoughts and ideas and we are able to reduce the projected deficit to a lesser figure than the administration has projected, that will have even an accelerated impact upon reduction of interest rates?

Mr. FELDSTEIN. Yes; unless the way it is done conjures up fears of inflation, per se. I will tell you what I mean by that cryptic remark.

I know there is a substantial discussion about eliminating tax indexing that will come into effect in 1985.

If you added that to the package that we have here, that, in itself, would lead to a projection of smaller deficits, but I think it would cause the financial market participants and others to fear that inflation was going to go up and not down and interest rates would rise.

I think that the prospect of using an unindexed tax system to generate——

POSTPONEMENT OF TAX DECREASE

Chairman HATFIELD. Or the postponement of the tax decrease?

Mr. FELDSTEIN. I am focusing on indexing here rather than anything else, because that is something, although it looks like a revenue raiser and a deficit reducer, ought to reassure financial markets that the deficit will be smaller. I fear postponement would have just the opposite effect because it would cause a fear that the inflation would increase revenue and that policies would be tilted more toward inflation.

Chairman HATFIELD. Let's restrict it to the spending part of the budget. What if we suspended the military budget for 1 year?

Mr. FELDSTEIN. I can think of all kinds of reasons why that would be a bad thing to do.

Chairman HATFIELD. That is the spending side. That is not indexing, not the revenue side. That is purely the spending side.

Mr. FELDSTEIN. You are asking me what impact that has on the deficit, per se, and as a result, on interest rates. Virtually anything you did on the spending side would have a positive, favorable effect.

Chairman HATFIELD. I am overstating the case to make a point. Are you saying that reductions in military spending are not going to have much impact, even though we can relate it to a lesser deficit?

Mr. FELDSTEIN. No; I am saying that any reduction would have an impact. Any reduction in spending, military or nonmilitary, would have a favorable impact on deficits and further deficits.

Chairman HATFIELD. And in turn, a reduction in deficits would bring a reduction in interest rates?

Mr. FELDSTEIN. That is right, although I would emphasize that it is the continuing deficit, the outyear deficit, and the prospects for the continuing level of Government borrowing, rather than any one-time effect on the deficit.

Chairman HATFIELD. I couldn't agree with you more on that. That is why I faulted the proposal of Secretary Weinberger to reduce the military by $8 billion because it had little or no impact on outyears. It protected the large weapons programs which have such a horrendous impact on outlays in future years. Senator Stennis?

BALANCED BUDGET BY 1984

Senator STENNIS. Well, Mr. Chairman, I want to say this: This statement is very helpful to me, certain parts of it in particular. It is written in understandable language, and it gets right down to the highest priority probabilities and so forth, and in that way, it helps me out.

I want to mention a matter, not necessarily a criticism, but we are told by our responsible people, acting in good faith, I am sure, that in 1980, we were going to have this budget balanced in 1984; I am talking about calender years now. When I came here I had really rather a conservative voting record on money, and I could, but with great relish, I went to casting some votes that calculated some small reductions at least.

Then all of a sudden, we are faced with these large deficits. The debt was getting larger and larger and we are faced with a $200 billion deficit within the next year, just a little beyond 1984; other years are less than that, but not too much less and now where does that leave us and what are we going to rely on? I would not say I disbelieve all of it. What are we going to rely on most, and what is the businessman going to rely on? What are people generally going to rely on? We have to live with these things, but you have made a statement here that is helpful to a degree.

Now, this increase of the national debt, what will be the effect of that? If we just keep on going up or hanging around these high figures; what will be the general impact?

Mr. FELDSTEIN. Well, the effect will be very serious, Senator.

Senator STENNIS. Yes; describe it for me.

Mr. FELDSTEIN. Well, the large deficit would mean that the funds that might otherwise be available for investment and plant and equipment would, instead, be going to finance the accumulation of the Government debt, and over time, that would leave us with a smaller capital stock. It would leave us with less machinery and equipment for our workers; less housing in the country. It would mean that productivity and real wages would not rise as fast as they otherwise would.

So the cumulative effect of it, would, indeed, be very serious.

AVOID INCREASE IN NATIONAL DEBT

Senator STENNIS. Well, it just adds up to a demand that we avoid this greatly increased, continuing increase in the national debt. Isn't that what we are faced with and we have to do?

Mr. FELDSTEIN. I think so, yes.

Senator STENNIS. And people are naturally concerned; some complain about reductions, but whatever is necessary to be done to preserve the economy has got to be done; isn't that correct?

Mr. FELDSTEIN. That is, indeed, correct.

COST SAVINGS IN PROGRAM ADMINISTRATION

Senator STENNIS. We just meet that in the road, and the question is, what are we going to do with it?

I thought I would help make a start or I was helping to make a start when we started voting on this matter in 1981. I had been concerned before then, but it looked like we were on our way, and if that would not work, well, then, we will have to start over.

In your work, do you attempt to make any examinations, calculations, and estimates on how much could properly be saved by better administration of these programs?

Mr. FELDSTEIN. I have not.

Senator STENNIS. I have gone around and looked behind the door and poked into these offices to see what they are doing. The way I think, there could be some savings. Have you done that?

Mr. FELDSTEIN. No; I have not done that.

Senator STENNIS. I judge that is beyond your purview of your call of duty, right?

Mr. FELDSTEIN. That is correct. That would fall to OMB rather than to the Council of Economic Advisors.

Senator STENNIS. You did not come here looking for advice, but let me venture to give you a little. You cannot go out and do that yourself, but get somebody to take a look at what is going on in the administration of these programs. I tell you, I think great savings can be made without diminishing the necessary services at all, and just be specific about it. I think some of that can be done in medicare, for example, a very important program; highly important, but I believe it wise not to overfund, but it should just be reasonably funded with administration and enforcement and carrying out of the real purpose to the letter of the law. A great number of these programs could make a substantial reduction. We of the Congress cannot get at that very well. Our primary function is we try, but we do not get at it very well. It is an executive function. What is your comment on that?

Mr. FELDSTEIN. In the medicare area, there certainly are opportunities for substantial savings. The medicare program has been growing, as you know, very rapidly and will, by 1988, be about $100 billion.

Senator STENNIS. Yes.

Mr. FELDSTEIN. The administration has submitted a plan for prospective reimbursement that we hope will keep down the costs under the medicare plan by giving the hospitals more incentive or reward for keeping their costs in line. But I think you are absolutely right; we do need to provide those kinds of incentives and pressures to keep costs down in those plans because they have been growing at a tremendous rate.

Senator STENNIS. I was not picking that one out as a whipping boy or anything. I just picked it out because I have looked into it a little and also I was not sure I was trying to pick on a weak link program or anything of that kind, but something has got to be done in these fields. We cannot go on. Congress has added on too many benefits already. There is no money to pay for them. It was not there when we put the benefits on, back then; inflation, high interest rates and so forth, but this thing has got to be headed off somewhere.

Mr. Chairman, I will make this brief. I have some questions here that relate to the idea of living with this additional high national debt. I am not nervous about it, but I know you cannot continue to live with such growing figures as we are having. I have questions here I would like to have the witness' opinion on. I will ask that these four or five questions that I have written be inserted in the record.

Senator RUDMAN [presiding]. Without objection that will be in the record and will be answered for the record.

Senator STENNIS. Do you understand where we are coming with this?

Mr. FELDSTEIN. I will be happy to answer them.

Senator STENNIS. If you have time to do it, I would be pleased.

Senator RUDMAN. Senator McClure?

EFFECT OF HIGH INTEREST RATES ON ECONOMY

Senator MCCLURE. Thank you very much, Mr. Chairman. I am very pleased to see you here this morning.

If we ask some questions, it is because many of us are a little perplexed, and I am certain we all share the concern the administration does about where we are going.

Are you one of those who believes that high interest rates have been damaging to the recovery?

Mr. FELDSTEIN. Yes, I do.

Senator MCCLURE. Are you also one of those who believes that the spread between the rate of inflation and the interest rates is abnormally high?

Mr. FELDSTEIN. Yes.

Senator MCCLURE. Are you also one of those who believes that that spread is caused by skepticism in the money markets about the future course of the economy?

Mr. FELDSTEIN. One is the skepticism, the fear that we will revert to inflation again; and the other, wholly unrelated to that, is the large budget deficits. I think the budget deficits in the outyears play a double role. They conjure up fears of inflation, not unjustifiably, and thus keep that inflation premium in the interest rates. But if there weren't any inflation premium, the fact that the Government would be potentially bidding for such a large share of national savings would keep real interest rates high.

So both of those keep the interest rate up.

Senator MCCLURE. So the deficit plays against that spread or contributes to that spread in those two ways in your opinion?

Mr. FELDSTEIN. That's right.

PRIVATE SAVINGS

Senator MCCLURE. In 1984, the deficit is predicted to be very large, and it is also predicted to absorb some 94 percent of net private savings; is that correct?

Mr. FELDSTEIN. That sounds right.

Senator MCCLURE. And that is even though there is modest recovery in the economy?

Mr. FELDSTEIN. Correct.
Senator MCCLURE. We have seen a growth in that private savings. Over the last year, the savings rate has increased?
Mr. FELDSTEIN. Uh-huh.

DECLINE IN CORPORATE AND BUSINESS LIQUIDITY

Senator MCCLURE. We have also seen, over the last 2 years, a decline in liquidity of most corporate and business enterprises in this country; is that correct?

Mr. FELDSTEIN. I would have said more recently the corporations were increasing their liquidity at least by some measures.

Senator MCCLURE. The reason I ask those questions is if, as a matter of fact, we are going to absorb savings by relationship to the Federal debt, and at the same time we expect some recovery, that recovery must be financed. In December, with the rise in silver prices, a mine in Idaho reopened and put some men back to work. That was good news.

At the same time, they had to go to the market with an issuance of common stock in order to pay their wages. Is that a typical pattern that we can expect to develop as businesses begin to expand again?

Mr. FELDSTEIN. Well, it is not typical, certainly, to finance short-term outlays by new equity issues. But as I said in the prepared testimony, while real interest rates have been rising, the cost of equity capital has been falling. The stock market has been going up substantially in real terms in recent months. So we would expect some shift in the way firms chose to finance their outlays in the direction of equity.

OPEN MARKET FINANCING OF EXPANSION PROGRAMS

Senator MCCLURE. All right. Let me focus it, then. You chose a different portion of my comment upon which to comment; that is, you chose to look at how they would go to the market to finance the expansion.

But they will have to go to the market to finance the expansion; is that not correct?

Mr. FELDSTEIN. Yes. Yes.

Senator MCCLURE. They don't have enough liquidity to finance their expansion initially without going to the market one way or another.

Mr. FELDSTEIN. Correct.

Senator MCCLURE. At the same time, they are going to the market to finance expansion they will also be in increased competition with the Federal Government for availability of funds.

Mr. FELDSTEIN. That's right.

Senator MCCLURE. If that is the case, are interest rates likely to continue to fall in the phase of economic recovery?

Mr. FELDSTEIN. I think that long-term rates can fall if markets become convinced that the Government in the outyears is going to get these deficits under control and keep inflation under control.

Senator MCCLURE. But that is assuming that there is money for both the short term and long term, but if there is a shortage of money and the interest rates are high and the risk is relatively low for short-term in-

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vestment, won't all the money go to the higher cost, higher interest rates, short-term market?

Mr. FELDSTEIN. No; because there still are a lot of investors who have a desire to be at the long end of the market.

Senator MCCLURE. Has that been true the last 2 or 3 years?

Mr. FELDSTEIN. Well, until the last year, or the last 6 months, there has been a great shortening of maturity. You are absolutely right.

Senator MCCLURE. They chose the relatively risk-free and many times Government securities in the short-term market that yielded very high rates of return and no risk. Isn't that likely to occur again?

Mr. FELDSTEIN. Well, it is certainly true that the Government is going to get whatever funds it wants. So to the extent that the Government runs $100 or $150 billion deficits, it will come first in the queue. It will crowd out whoever else has to be crowded out to get those funds.

Senator MCCLURE. If that is the case, then, we will have two phenomena occur: Either there will be a lack of available capital, and the Government, including the Federal Reserve, will have to determine how they meet that challenge in making a sufficient quantity of capital available; isn't that, in itself, likely to be inflationary?

Mr. FELDSTEIN. Not necessarily. I think that the Fed can continue to pursue a policy which will have other adverse effects but will not be inflationary. It will have adverse effects, because to the extent that the Government is borrowing and crowding out other kinds of private activity, we will have a very lopsided economic expansion.

Senator MCCLURE. And if they act to stem the inflationary pressures, then you are talking about a tight money policy again.

Mr. FELDSTEIN. Not a policy in which interest rates rise sharply, but a policy in which the Fed continues to monitor and maintain slow growth of the monetary aggregates.

PROTECTION AGAINST NEW RISE IN INTEREST RATES

Senator MCCLURE. I am sure you know where my questions are leading. I wonder how we can finance business recovery and Federal debt and have a tight money policy without driving interest rates to the point that they, instead of dropping further, rise again and choke off the recovery.

Mr. FELDSTEIN. That is a complicated question.

I think that I agree with the thrust of the question that if we have large deficits, they are going to crowd out private investments. They are going to reduce economic activity in the investment goods industries and in those industries that involve construction and production of materials that go into investment goods and construction.

We would have a very lopsided recovery, and that might be a more fragile recovery than we would otherwise have. That is why it is so important that we get the deficits moving rapidly down.

METHODS OF REDUCING DEFICIT

Senator McCLURE. One final question, Mr. Chairman. I appreciate your allowing me to ask these questions at this time. I do need to be on the floor, and it is a closed session.

We have two ways, or combinations of the two to reduce the deficit: Either by decreasing expenditures or increasing taxes.

In light of the economic needs of the country, which is the better way to do it?

Mr. FELDSTEIN. In many ways it is a question of choice about how we want to spend our national resources.

My own preference is for us to continue to move as much as we can in bringing down the level of spending.

Senator McCLURE. The more we increase taxes, the more we are assigning the available capital to those expenditures which Government chooses. Is that not correct?

Mr. FELDSTEIN. The more we—in effect, yes.

Senator McCLURE. Because we tax away from the capital markets those moneys that might have been placed in the capital market, capital and expenditure markets.

Mr. FELDSTEIN. A lot of that depends on the particular form of taxation. But it is certainly true that to the extent that we don't reduce spending and, instead, raise taxes, we are allowing the Government to decide how those resources are going to be spent.

ALL-SAVERS CERTIFICATES

Senator McCLURE. In the short term, Congress introduced all-savers certificates. When we did that, we eliminated the interest exclusion.

That interest exclusion will reappear in 1985. What effect does that have on savings?

Mr. FELDSTEIN. The interest exclusion that I believe is scheduled to reappear in 1985—correct me if I am wrong—is a 15-percent exclusion up to a quite high ceiling.

Senator McCLURE. Yes; up to $3,000.

Mr. FELDSTEIN. I think that will have a positive effect.

Senator McCLURE. When it reappears.

Mr. FELDSTEIN. Yes; when it reappears.

Senator McCLURE. But the elimination between now and 1985?

Mr. FELDSTEIN. I think it is the uncertainty about whether it will come back that has the principal adverse effect now. I think that since it is a reward for having assets, for having saved, it is an interest exclusion rather than a reward for saving in a particular year. The fact that we don't have it in 1984 is not that important. The critical thing is to be certain it not get lost in the shuffle of budget policy in the coming year.

Senator McCLURE. There you get down to the question of which is going to be Government policy: Raising taxes or lowering the deficit, but if we were to advance the exclusion to 1984, would that not give the assurance to the market or to the investors that it will be there in 1984 and 1985? It would reduce the revenues to Government and in-

crease the deficit in 1984. Which is the more important, to give that signal, to give that incentive to savings or to reduce the deficit by that amount?

Mr. FELDSTEIN. A very difficult question.

Senator MCCLURE. I know that, but we are going to have to answer it.

Mr. FELDSTEIN. I think if, in fact, you answered the question by not changing the law for 1985, if the Congress reaffirmed its commitment to that for 1985, that would be a positive step.

Senator MCCLURE. Even though it increased——

Mr. FELDSTEIN. I hasten to do anything to further increase the deficit at this time, but I do want to stay there.

Senator MCCLURE. You do have tax revenues in 1984 and the assurance for savings in 1985, so they will pay the taxes in 1984 and save, too.

Mr. FELDSTEIN. It would be nice if you could have it both ways.

Senator RUDMAN. If we have such a plan, I think it might be wise.

Senator MCCLURE. Thank you very much, and thank you, Mr. Chairman.

INTERNATIONAL DEBT SITUATION

Senator RUDMAN. Dr. Feldstein, I think most of the questions that I would want to ask have been asked. I just have one, and then we are going to hear from Dr. Rivlin almost on schedule.

On page 12 of your statement there appears a paragraph which I think has far more significance than currently is being given credit. It says, "The seriousness of the international debt situation may have other adverse consequences on the recovery. At a minimum, American banks with illiquid loan portfolios may restrict some domestic spending and accumulate larger reserves during the coming year." And then you end with this sentence. "The banks' need to channel substantial additional resources into increasing their foreign loans will also alter the character of bank lending in the United States."

I wonder if you might amplify that very short but, I think, very interesting statement?

Mr. FELDSTEIN. Yes; well, I think first, the banks that have made loans to countries like Brazil, Mexico, and Argentina found that those countries are not in a position to repay those loans at the present time. Although they are making some payments, the current plans worked out with the IMF and directed by the banks will increase the supply of credit to those countries so that the banks will actually be increasing their total loans to Brazil, Mexico, Argentina, and other developing countries at a time when, frankly, they would rather not be doing that. But they must do it in order to allow time for these countries to work out their financial and economic problems.

Senator RUDMAN. And I assume by so doing, reducing or contracting by whatever amount that is available for domestic lending which, of course, would impede the recovery.

Mr. FELDSTEIN. Not quite. We are going to be importing from the rest of the world in 1983 probably on the order of $30 billion of capi-

tal, offsetting capital flow to our current account deficit. I think that specific loans made by our banks into Latin America or elsewhere will induce offsetting additional capital flows coming into the United States. The exchange rates will change and the whole complex process will work its way out.

That is why I use the word, "the character" of bank lending rather than the total amount. Faced with the kind of risks that the banks see themselves having in their LDC lending, they may seek to pursue a much safer course of domestic lending than they would otherwise. They may seek to build up reserves and to do that lending in the form of holding short-term Government securities rather than making additional risky loans in the United States.

One shouldn't think of it as a dollar loaned to Mexico is a dollar not loaned inside the United States.

EFFECT OF FOREIGN LENDING ON AMERICAN BORROWERS

Senator RUDMAN. Irrespective of the total amount of capital inflow into this country, the fact is that the banks need to increase their foreign commitments which would decrease the net amount that is available from both internal and external sources in terms of lending to American borrowers.

Mr. FELDSTEIN. Unless it increases additional capital flows from the rest of the world. When we go to lend money abroad, we have the effect of altering the exchange rate in ways that induces an initial flow of funds from the rest of the world.

OVERSIGHT OF U.S. BANK LOANS TO FOREIGN COUNTRIES

Senator RUDMAN. Just one last point: I believe yesterday the President was quoted as saying that the administration favors some form of regulation, oversight on the character and amount of loans made by American banks to foreign countries, but exhorting the Congress not to try to get into micromanagement of that itself, but leave it to regulators. I assume you do agree with that position?

Mr. FELDSTEIN. I think it is something that we really have to be putting a lot more attention on at this point, deciding just what is the appropriate way to deal with the situation in the future.

Senator RUDMAN. Dr. Feldstein, on behalf of Chairman Hatfield, who had to leave for an important meeting, I want to thank you for appearing. Your statement has been very concise and very comprehensible. Thank you.

Mr. FELDSTEIN. Thank you very much.

SUBMITTED QUESTIONS

Senator RUDMAN. Additional questions have been submitted to you for response in the record. They will be inserted at this point.

[The following questions were not asked at the hearing but were submitted to the department for response subsequent to the hearing:]

Questions Submitted by Senator Hatfield

Q. In recent years the American economy has been in a period of starts and stops, with 2 recessions alone since 1980. Is a healthy, long-lasting period of recovery attainable now, or are we doomed to further short term ups and downs?

A. I believe that a healthy and long lasting recovery is indeed attainable if we don't make the mistake of following policies that overheat the economy and require periods of "cooling off".

Q. Unemployment figures have been on an adverse trend ever since 1970. The average unemployment in the 60's was 4.8%; for the first half of the 70's it was 5.4%; for the last half of the seventies it was 7.0%, and thus far in the 80's it has averaged 8.1%. This time frame is long enough to factor out recessionary periods. Recovery from recession brings improvement, but not all the way back to previous levels. Why? Do we face worse and worse statistics in the future, or is there reason to think we can turn this around?

A. There is no doubt that there has been a trend increase in the unemployment rate. The "inflation threshold" level of unemployment, that is, the lowest level of unemployment that can be maintained indefinitely without causing inflation to rise is now probably between 6 and 7 percent. This increase of perhaps a full percentage point or more over the past quarter century reflects a number of trends including the increased labor force participation of women and young people, changes in unemployment insurance, and changes in work registration requirements. The demographics will improve in the 1980s and that should help to bring down the inflation threshold level of unemployment. In addition, the Administration's program aimed at structural unemployment should bring it down even further.

Q. You have remarked that public works jobs programs have considerable lags between the time that the legislation is passed and the time it has any discernable effect on the employment market. The Economic Report of the President cites lag periods of up to 2 1/2 years from the trough of the recession to the peak of employment. Do you believe a public works program which simply accelerates existing projects could have an immediate, positive impact on the labor market?

A. In general, there is a long lag between the legislation and the employment effects of public works projects. I am told by OMB that the proposed speed-up of projects to 1983 is feasible because of the nature of the projects and stage of preparation.

Q. Some economists have argued that the Federal Reserve can relax monetary controls for a lengthy period without retriggering inflation, because of the depressed state of the economy. How long do you believe we can permit money to expand at the rates seen in the last half of 1982 without an inflationary spiral? Is the Federal Reserve being too accommodative by trading short-term economic gains for another bout of inflation in the future?

A. I do not agree that it is possible for the Federal Reserve to relax monetary contols without retriggering inflation. There is no threshold level of unemployment above which inflation is not a problem, the faster we expand the economy and the faster we shrink unemployment, the more increases in prices we will, all other things equal, have. I do believe, however, that the rapid expansion of the narrow money aggregate in the second half of 1982 and the rapid expansion of both the narrow and broad aggregates in the first months of 1983 do not represent an over-expansion of the money supply but a shift of the deregulation legislation enacted last year.

I know that the Administration wants to lower the inflation rate from its current level and, although we are very pleased with the substantial gains that have been made in the past two years, it remains our aim to bring the inflation rate even lower.

Questions Submitted by Senator Stennis

Q. Total federal debt first exceeded $1 trillion in 1981. OMB forecasts that debt to rise to $1.38 trillion in FY84 and to $1.98 trillion in FY88. During the 1970's decade, debt was 35-40% of total GNP. OMB forecasts it will grow to 46% of GNP in FY84 and to 50% of GNP by FY88, under the Administration budget plan. What is your view of the impact that this steadily growing and large debt will have on our economy? Can we continue to pick up this debt at a faster rate than the GNP is growing? What impact will this large debt have on interest rates for the future? Can the government expect to finance this debt without setting off another round of inflation?

A. Steadily growing debt as a larger and larger share of the economy will have adverse effects. In particular, it will reduce the rate of capital formation and therefore the rate of growth of productivity in real incomes. We cannot continue to accumulate debt at a faster rate than GNP is growing without having such adverse consequences. The increased government supply of debt relative to total income and wealth will raise real interest rates, although market "nominal" interest rates can fall in inflation and inflation expectations continue to diminish. I do believe that the government can finance such debt without setting off another round of inflation if monetary policy is correct. That would not however reduce or eliminate the adverse effects on growth and capital intensive activities.

Q. You say that the $75 billion trade deficit will depress domestic demand in the first year of recovery. Do you think this trade deficit could put economic recovery at risk? You attribute this trade deficit to the high exchange value of the dollar. Is this high exchange rate due to high U.S. interest rates? Can the U.S. reduce this trade deficit without reducing U.S. interest rates? Are there other steps, such as import taxes or "Buy American" provisions that would decrease imports and increase exports and help our economy?

A. A very large trade deficit, equal to two percent or more of GNP, would be a completely new experience for the

U.S. economy and would certainly prevent us from having the broad based and healthy recovery that I would like to see. The trade deficits reflect the high exchange value of the dollar as well as the low level of real ecoomic activity elsewhere in the world. The principal reason for the high exchange value of the dollar is the high level of U. S. interest rates. The principal way in which the trade deficit could be reduced is by reducing the high exchange value of the dollar and this in turn can most easily be done by reductions in real long term interest rates. Import taxes or buy-American provisions would potentially decrease imports but that would simply cause the dollar to strengthen further and reduce our exports. The only way to cure the trade deficit is by altering the exchange rate.

Questions Submitted by Senator Leahy

Q. Mr. Feldstein, in your testimony, you mentioned two factors limiting recovery: 1. High real interest rates. 2. Large foreign trade deficits. Both of these are directly affected by the Federal Reserve's monetary policies. The recovery projected is a very weak recovery. Would the recovery be stronger if the Federal Reserve policies were changed?

A. I believe that the high real interest rates and large foreign trade deficits are due primarily to the large budget deficits that we face in the second half of the 1980s and not to current monetary policy. If the Federal Reserve pursued a more expansionist policy and allowed the monetary aggregates to expand more rapidly, I would fear that that would have the effect of overheating the economy by a surge of activity which, when it was reduced, would cause a decline or elimination of the recovery. In short, I think that more expansionary policy by the Federal Reserve could be counterproductive and weaken the prospect for a sustainable recovery.

Q. You have testified that we must bring down the deficits so that inflationary expectations -- and therefore interest rates -- will come down. You have stated that it is the deficit, not monetary policies, that are critical in establishing interest rates. Professors Tobin and Thurow have stated that real interest rates on overnight federal loans -- where inflationary expectations play no role -- are several times higher than during earlier recessions. Do you agree that more growth-oriented monetary policies would increase the rate of recovery? Why are interest rates on short-term borrowing so high?

A. The short-term high real interest rates reflect a combination of things. First is the basic supply and demand for funds. With large budget deficits here and abroad, it is not surprising real interest rates here and everywhere in the world are kept high. In addition, the process of disinflation has kept real interest rates high. This is something that has happened in the past when inflation has come down. More generally, when inflation increases real rates of interest tend to fall and when inflation decreases they tend to rise.

CONGRESSIONAL BUDGET OFFICE

STATEMENT OF DR. ALICE RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

REESTIMATE OF ADMINISTRATION BUDGET TO CONGRESS

Senator RUDMAN. I call on Dr. Alice Rivlin. Dr. Rivlin is here this morning at the request of the committee to present a reestimate of the President's budget submission to the Congress. Again this year, this request to do the reestimate was forthcoming from the committee.

Dr. Rivlin, we want to thank you very much for coming here this morning and testifying before us. Of course, we know you are in your last year of 2 very exemplary 4-year terms of, we think, excellent leadership of the CBO. We thank you very much for being here this morning.

Ms. RIVLIN. Mr. Chairman, I am delighted to be here. I am sorry that I do not have with me copies of our analysis of the President's budget. We got caught in the great blizzard of 1983, and the actual copies of our analysis will be delivered, we hope, tomorrow.

However, I will talk today about our results. Lest you have not enough to read, let me say that we do already have our three-volume annual report to the budget committees, which goes over our forecast of the economy, our analysis of deficits on a current policy basis, and alternatives that we hope the Congress will find useful as it considers ways of reducing the deficit.

I will, today, touch briefly on four major topics: First, the economic outlook and the near-term prospects for recovery; second, the prospect of large and growing budget deficits under existing tax laws and spending policies, even after the economy recovers from the current recession; third, the administration's budgetary proposals for reducing these large and troublesome deficits; and finally, the results of CBO's technical analysis of the President's 1984 budget.

THE ECONOMIC OUTLOOK

The recession in the U.S. economy, which was initiated by high inflation and tight credit conditions, is now the most severe of the post-World War II period. At the same time, however, the inflation picture has improved markedly. The combination of record slack in the U.S. economy and a depressed world economy has sharply reduced inflationary pressures.

A year ago, CBO—as well as everyone else—projected a recovery during 1982. That recovery did not materialize because of very high interest rates in the first half of the year. Beginning last July, however, interest rates fell in response to the weakness of the economy, declining

inflationary expectations, and an easing of monetary policy. As a result, CBO and other forecasters are again predicting a recovery; indeed, fairly broad-based evidence of an upturn in the months ahead now seems clear. The inventory decline appears to be slowing; auto production is rising; a sharp rise in housing starts suggests a pickup in residential construction; and consumer balance sheets suggest that they are in a position to increase spending.

There are reasons to believe, though, that economic growth will be less vigorous in this recovery than in past recoveries. Interest rates, after adjustment for inflation, remain at historically high levels, and business investment is not expected to pick up for some time to come. Exports are expected to remain weak both because of the high value of the dollar and because of continued recession abroad.

POLICY ASSUMPTIONS

The CBO short-run forecast, which is shown in table 1, incorporates the following policy assumptions:

First, we assume that the tax and spending policies will be those that were in effect at the end of the 97th Congress. Accordingly, we are assuming that defense spending for fiscal year 1984 will be at a level that is consistent with the budget resolution for fiscal year 1983.

Second, with regard to monetary policy, we assume that the broad money aggregate, M–2, will grow at 9-percent annual rates during 1983 and 1984. However, if velocity growth deviates sharply from average historical growth rates—as it did in the past year—we assume that the Federal Reserve will adjust its money targets in an attempt to insure moderate growth in nominal gross national product.

The short-run forecast also assumes no food or fuel shocks. However, an assumed 10- to 15-percent decline in the trade-weighted value of the dollar is expected to exert some pressure on prices by raising the costs of imported goods.

The CBO baseline economic forecast shows real growth in GNP at 4 percent from the fourth quarter of 1982 to the fourth quarter of 1983 and at 4.7 percent in the next year. The unemployment rate is expected to decline very gradually to 9.4 percent by the final quarter of 1984. Inflation, as measured by the GNP deflator, is forecast at 4.7 percent in 1983 and slightly less in 1984. Short-term interest rates, as measured by the Treasury bill rate, are projected to average 6.8 percent in calendar year 1983, rising slightly as the recovery proceeds to 7.4 percent in calendar year 1984.

The CBO projections after 1984 are not a forecast but merely assumptions about attainable growth and price behavior. Real GNP is assumed to grow at an annual rate of 3.6 percent and unemployment to decline slowly to 7.5 percent by 1988. Inflation is assumed to decline very gradually to 3.8 percent by 1988. Both short-term and long-term interest rates are assumed to drift down slowly in the outyears, though at a somewhat faster pace than the decline in inflation.

The administration's economic assumptions for fiscal year 1984 show the same basic pattern as the CBO baseline assumptions. As shown in

table 2, the CBO projection is somewhat more optimistic about real growth and inflation during the next 2 years. I think this is the first time we have been on the optimistic side of the administration. After 1984, however, the administration shows slightly higher growth and a faster decline in unemployment and higher inflation. The differences are really quite small.

THE BUDGET OUTLOOK UNDER CURRENT POLICIES

Although the economy is expected to begin its recovery this year and to move into a period of continued growth, budget projections by both the administration and the CBO show steadily rising deficits under existing tax laws and current spending policies. These are graphically shown in figure 1. This is the same budget outlook seen last year at this time, but the magnitude of the deficit problem has increased despite actions taken by the 97th Congress to reduce spending and increase revenues.

The primary reason why the budget deficit problem is worse now is the poor performance of the economy last year. As a result, the budget deficit for 1983 is currently expected to be about $194 billion, almost double the $104 billion target that the Congress set last year in its budget resolution.

CBO estimates that Federal revenues will be $606 billion in 1983, $12 billion below the amount collected in 1982 and $60 billion below the budget resolution target.

Federal outlays in 1983, on the basis of actions taken by the 97th Congress, are now estimated to total about $800 billion, or $30 billion more than projected by last year's budget resolution. Most of this rise is the result of higher costs for unemployment benefits and farm price supports and lower Outer Continental Shelf receipts.

Looking ahead, revenues are projected under existing laws to resume their growth as the economy recovers, but the growth in revenues is projected to be slightly lower than the growth in the economy. As a consequence, CBO projects revenues as a percent of gross national product to be only 18.4 percent in 1988, well below the post-World War II high reached in 1981 of 20.9 percent of GNP. The main reason for the decline in revenues relative to GNP over the 1984 to 1988 projection period is the large tax reductions enacted in the Economic Recovery Tax Act of 1981, reductions that were only partly offset by the Tax Equity and Fiscal Responsibility Act of 1982.

Under CBO's current policy assumptions, Federal outlays are projected to grow about as fast as revenues, increasing to more than $1.1 trillion by 1988. Relative to GNP, project outlays would decline slowly from 25 percent in 1983, the highest ratio since World War II, to 24 percent in 1988, a ratio still higher than for all the postwar years before 1982.

AREAS OF OUTLAY GROWTH CONCENTRATION

More than 90 percent of the projected $350 billion in outlay growth is concentrated in just four areas: National defense, social security, medicare and medicaid, and net interest costs. These four components

will account for 68 percent of total outlays in 1983 and 75 percent of total outlays by 1988 under CBO's policy assumptions.

The CBO projections show that, if no changes are made in tax laws and spending policy, the budget deficit would rise to about $200 billion in 1984 and then grow gradually to nearly $270 billion by 1988. The current services projections of the Office of Management and Budget also shows rising budget deficits over the next 5 years under current policies. You can see those in figure 2. Actually, OMB's budget deficit projections are higher than CBO's, but about 60 percent of these higher deficits result from different definitions of current policy for national defense programs.

OMB's current services projections use the administration's defense proposals in the 1983 budget as the definition of current policy for 1984 through 1988. CBO's baseline projections use the defense spending targets in last year's budget resolution for 1984 and 1985 and extrapolate these targets to 1988. So that is a lower number. The cumulative 5-year difference between the two current policy projections of national defense outlays is about $120 billion. If the same national defense spending assumptions were used, the two deficit projections would be much closer.

DIFFERENCE IN CURRENT POLICY ASSUMPTIONS

Senator RUDMAN. I wonder if I might interrupt at this point and ask if you would give us an explanation of the factors that go into this kind of an enormous difference in assumptions used by the administration.

It seems to me one of the great problems we have is to understand how these assumptions are derived, and this $120 billion amount is somewhat startling since you are using the same basic language, I assume.

Ms. RIVLIN. What we are trying to do in a baseline is to say, "What would happen if you don't change policy?" That raises the question, "What is policy?"

Since we work for the Congress, we always take the last congressional expression of policy. That meant that we took the budget resolution passed for fiscal 1983 and projected that forward. That is what we think congressional policy is.

The administration, on the other hand, takes as its definition—and I am not quite sure why—its last year's budget submission which was higher. That is really just a fairly arbitrary definition of what do you mean by current policy.

Senator RUDMAN. So obviously, if we were to assume that the Congress were to retain its consistency in advancing its policy over the next 5 years, then your projections would tend to be more accurate than theirs?

Ms. RIVLIN. That is right. Now, it is only in defense, I should try to point out, that this problem arises.

Senator RUDMAN. I understand that.

THE ADMINISTRATION'S BUDGETARY PROPOSALS

Ms. RIVLIN. The President's 1984 budget spells out a plan for reducing the budget deficits over the next 5 years. If this plan were adopted, the administration estimates that the deficit would be sharply reduced from a current policy level but would still exceed $100 billion by 1988.

How to characterize the President's plan depends upon what baseline is used for a starting point. The administration describes its deficit reduction plan as amounting to more than $550 billion over 1984 through 1988, with reduced spending accounting for nearly 60 percent of the lower deficit. These spending reductions would include $47 billion of lower defense outlays over the next 5 years. Nondefense program outlays would be cut by $201 billion, and the net interest cost savings resulting from lower deficits would account for $76 billion. The remaining $234 billion in deficit reductions would come from increased revenues, with the contingency tax proposals accounting for $146 billion, or more than 60 percent of the revenue increase.

INCREASE IN DEFENSE SPENDING

Using CBO's baseline projections as a starting point, however, gives a different cast to what the administration's deficit reduction plan is. Instead of a reduction in defense spending, the President's 1984 budget would result in a $75 billion increase in national defense outlays over the next 5 years relative to CBO's baseline projections. Outlays for nondefense programs would be cut by $176 billion, and net interest costs would be reduced by $30 billion. Relative to CBO's baseline projections, total outlays would be lowered by $131 billion over the 1984–88 period. CBO estimates that the administration's tax proposals would add $201 billion to the projected 5-year revenue stream. The total deficit reductions would accumulate to $332 billion by 1988.

The administration's budget plan relative to CBO's baseline projection is depicted in figure 3. Under CBO's estimates, which I will describe in more detail in a minute, the budget deficit would be reduced to about $150 billion by 1986 and remain at approximately this level for the next 2 years. As a share of GNP, the budget deficit would fall steadily from 6.1 percent in 1983 to 3.3 percent by 1988. This would be slightly higher than the administration's estimate of 2.6 percent of GNP.

SOCIAL SECURITY REFORM

The administration's 1984 budget includes the recommendations of the National Commission on Social Security Reform to provide solvency to the social security retirement trust fund. The effects of the commission's proposals would be to add $50 billion to the unified budget revenues during the period 1984 through 1988 and to reduce outlays by about $17 billion. Spending for other entitlement programs would be cut by an estimated $74 billion, of which the largest portion, $29 billion, would be in medicare and medicaid. Under the administration's proposals, outlays for medicare and other entitlements, excluding social security benefits, would still rise from an estimated $221 billion in 1983 to about $270 billion in 1986, but their projected growth under CBO's baseline would be cut nearly in half.

NONDEFENSE DISCRETIONARY PROGRAMS

Nondefense discretionary programs also would be cut back significantly from current policy levels. Outlays for these programs, which will amount to about $145 billion in 1983, would be cut by $61 billion during the 1984–88 period. Relative to CBO's baseline projections, which allow spending to keep pace with inflation, this represents a 50-percent reduction in the projected growth of nondefense discretionary outlays over the next 5 years. Under the administration's plan, outlays for nondefense discretionary programs would increase to $163 billion by 1988, but they would fall relative to GNP from 4.5 percent in 1983 to 3.4 percent.

CBO'S REESTIMATES OF THE PRESIDENT'S BUDGET

In the CBO's analysis of the President's 1984 budget, we have repriced the administration's revenue and spending projections using our own economic assumptions and technical estimating methods, as requested by this committee. Last year, you will remember, this process produced a dramatic change for the budget deficit projections, showing a rise instead of a decline in the deficit.

This year, we do not have major estimating differences with the administration. Our economic assumptions, while not identical, are fairly similar. The effects of CBO's slightly more optimistic assumptions for the near term would mean a somewhat lower deficit under the administration's budget proposals for the next few years, as shown in table 3. By 1987, however, use of CBO's economic assumptions would result in somewhat higher deficits, largely because of lower revenues. Let me stress, however, that neither of these differences are very large given the large errors that we all know come into these kinds of estimates over time.

EXCISE TAX ON OIL

The largest CBO technical reestimate of the administration's budget involves the administration's proposal for a temporary contingency excise tax on oil, both domestically produced and imported. Although the budget specifies a $5 per barrel tax, the revenue estimates are based on a $7 per barrel tax. CBO estimates that the $5 tax would raise approximately $9 billion less per year than reported in the budget or $27 billion less over the duration of the tax. Incidentally, the administration knows about this problem, and it is just one of those glitches that arise when the budget is put together quickly. They changed their mind and did not correct the numbers to reflect that.

Senator RUDMAN. I understand that is also correct. Staff advises me on the question I asked you about the defense assumptions, that the budget they submitted, in fact, as we finally got it, did have the slightly lower figures in it. I am going to check that with staff and maybe we can talk about it afterward.

Ms. RIVLIN. I am not sure what that refers to.

CBO has done a number of technical reestimates that are small in the aggregate and they do not add up to much.

Overall, the CBO reestimates suggest that the budget deficits in 1983 through 1985 would be somewhat lower than the administration projects assuming its budget proposals are adopted by the Congress. For 1987 and 1988, on the other hand, CBO projects somewhat higher deficits under the administration's plan. The estimating differences are slight, however. They remain well within the range of estimating error, particularly if the experience of the last several years is any guide.

CONCLUSION

In conclusion, Mr. Chairman, it is now widely agreed that further actions are necessary to reduce projected budget deficits. Given the composition and dynamics of the Federal budget, these actions will have to include both spending cuts and tax increases. Under current economic conditions, to avoid adverse effects on the economic recovery, it may be desirable to delay implementing major spending cuts and tax increases for a while. But as the recovery gathers momentum, the budget deficit will have to be reduced in order to ease Federal borrowing demands and permit increased private investment.

A reasonable target would be to reduce the budget deficit to between 1 and 3 percent of GNP by 1988. The administration has submitted one plan for moving toward the goal. During the next several weeks, the Congress will be considering this and other plans for reducing the Federal deficit. To aid in this process, CBO has laid out a wide range of possible strategies and options in the third part of our annual report, which was issued last week. We would be pleased to assist the committee in any other way that we can as it considers various approaches to reducing the projected growth in Federal spending.

Thank you, Mr. Chairman.

[The statement follows:]

PREPARED STATEMENT OF ALICE M. RIVLIN

Director
CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, I am pleased to have this opportunity to appear before the Committee to discuss the economic and budget outlook for the next several years. The Congressional Budget Office (CBO) has recently published its Annual Report to the Senate and House Committees on the Budget, which contains a good deal of detailed analysis in these areas. 1/ At the request of this Committee, CBO has prepared an analysis of the President's 1984 budget. 2/ Copies of that analysis will be distributed shortly to the Members of the Committee; our completion of the printed analysis was delayed by the blizzard of 1983. My statement this morning will summarize its contents. I will briefly touch on four major topics:

- The economic outlook and the near-term prospects for recovery;
- The prospect of large and growing budget deficits under existing tax laws and spending policies, even after the economy recovers from the current recession;
- The Administration's budgetary proposals for reducing these large and troublesome deficits; and
- The results of CBO's technical analysis of the President's 1984 budget.

1/ See Congressional Budget Office, Annual Report to the Senate and House Committees on the Budget, The Outlook for Economic Recovery--Part I, Baseline Budget Projections for Fiscal Years 1984-1988--Part II, and Reducing the Deficit: Spending and Revenue Options--Part III (February 1983).

2/ See Congressional Budget Office, Analysis of the President's Budgetary Proposals for Fiscal Year 1984 (February 1983).

THE ECONOMIC OUTLOOK

The recession in the U.S. economy, which was initiated by high inflation and tight credit conditions, is now the most severe of the post-World War II period. At the same time, however, the inflation picture has improved markedly; the combination of record slack in the U.S. economy and a depressed world economy has sharply reduced inflationary pressures.

A year ago, CBO projected a recovery during 1982; that recovery did not materialize because of very high interest rates in the first half of the year. Beginning last July, however, interest rates fell in response to the weakness of the economy, declining inflationary expectations, and an easing of monetary policy. As a result, CBO and other forecasters are again predicting a recovery; indeed, fairly broad-based evidence of an upturn in the months ahead now seems clear. The inventory decline appears to be slowing; auto production is rising; a sharp rise in housing starts portends a pick-up in residential construction; and consumer balance sheets suggest that they are in a position to increase spending. There are reasons to believe, though, that economic growth will be less vigorous in this recovery than in past recoveries. Interest rates, after adjustment for inflation, remain at historically high levels, and business investment is not expected to pick up for some time to come. Exports are expected to remain weak both because of the high value of the dollar and because of continued recession abroad.

CBO's short-run forecast shown in Table 1 incorporates the following policy assumptions:

- The tax and spending policies are those in effect at the end of the 97th Congress. Defense spending for fiscal year 1984 is at a

level that is consistent with the budget resolution for fiscal year 1983.

- With regard to monetary policy, the broad money aggregate, M2, is assumed to grow at 9 percent annual rates during 1983 and 1984. However, if velocity growth deviates sharply from average historical growth rates (as it did during 1982), CBO assumes that the Federal Reserve will adjust its money targets in an attempt to ensure moderate growth in nominal gross national product (GNP).

The short-run forecast also assumes no food or fuel shocks. 3/ However, an assumed 10 percent to 15 percent decline in the trade-weighted value of the dollar is expected to exert some pressure on prices by raising the costs of imported goods.

TABLE 1. THE CBO SHORT-RUN FORECAST

Economic Variable	1981:4 to 1982:4 Actual	1982:4 to 1983:4 Forecast	1983:4 to 1984:4 Forecast
Nominal GNP (percent change)	3.3	8.9	9.6
Real GNP (percent change)	-1.2	4.0	4.7
GNP Implicit Price Deflator (percent change)	4.6	4.7	4.6
Unemployment Rate a/ (calendar year average)	9.7	10.6	9.8
Three-Month Treasury Bill Rate (calendar year average)	10.6	6.8	7.4

a/ Excludes uniformed military personnel.

3/ Food prices are expected to rise moderately during the next two years, at 4 percent this year and 5 percent next year. World oil prices are assumed to remain unchanged through 1984.

The CBO baseline economic forecast shows real growth in GNP of 4.0 percent from the fourth quarter of 1982 to the fourth quarter of 1983 and 4.7 percent the next year. The unemployment rate is expected to decline gradually to 9.4 percent by the final quarter of 1984. Inflation, as measured by the GNP deflator, is forecast at 4.7 percent (fourth-quarter-to-fourth-quarter) in 1983 and 4.6 percent in 1984. Short-term interest rates, as measured by the three-month Treasury bill rate, are projected to average 6.8 percent in calendar year 1983, rising slightly as the recovery proceeds to 7.4 percent in calendar year 1984.

CBO projections after 1984 are not a forecast but merely assumptions about attainable growth and price behavior. Real GNP is assumed to grow at an annual rate of 3.6 percent, and unemployment to decline slowly to 7.5 percent by 1988 (see Table 2). Inflation is assumed to decline very gradually to 3.8 percent by 1988. Both short- and long-term interest rates are assumed to drift down slowly in the outyears, though at a somewhat faster pace than the decline in inflation.

The Administration's economic assumptions for the fiscal year 1984 budget show the same basic pattern as the CBO baseline. As shown in Table 2, the CBO projection is somewhat more optimistic about real growth and inflation during the next two years. After 1984, however, the Administration assumes slightly higher growth, a faster decline in unemployment, and higher inflation.

THE BUDGET OUTLOOK UNDER CURRENT POLICIES

Although the economy is expected to begin its recovery this year and to move into a period of continued growth, budget projections by both the Administration and CBO show steadily rising deficits under existing tax laws

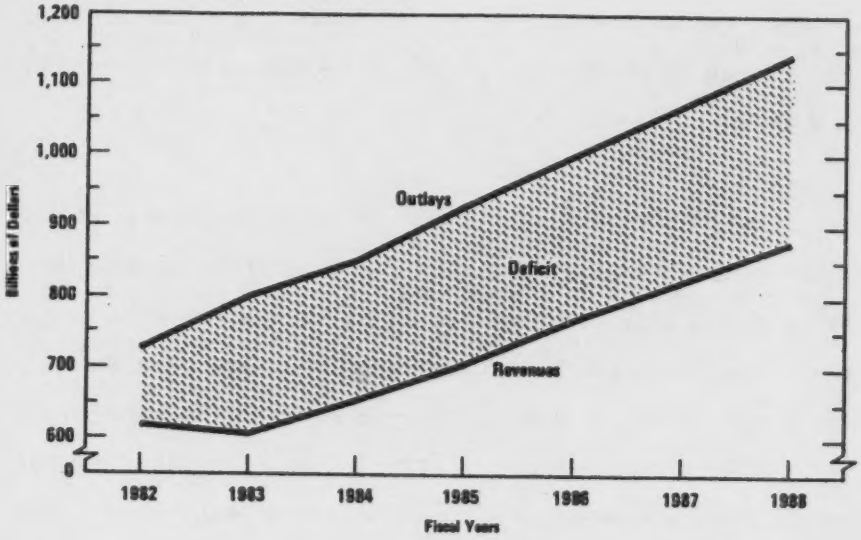
TABLE 2. COMPARISON OF CBO AND ADMINISTRATION ECONOMIC ASSUMPTIONS
(By calendar year)

	1982	1983	1984	1985	1986	1987	1988	1982:4 to 1983:4 Forecast	1983:4 to 1984:4 Forecast
Real GNP (percent change)									
CBO	-1.8	2.1	4.7	4.1	3.7	3.5	3.5	4.0	4.7
Administration	-1.8	1.4	3.9	4.0	4.0	4.0	4.0	3.1	4.0
GNP Deflator (percent change)									
CBO	6.0	4.6	4.7	4.7	4.3	3.9	3.8	4.7	4.7
Administration	6.0	5.2	5.2	4.9	4.6	4.5	4.4	5.6	5.0
CPI-W (percent change)									
CBO	6.0	3.8	4.6	4.4	4.1	3.9	3.7	3.8	4.5
Administration	6.0	4.9	4.6	4.6	4.6	4.5	4.4	5.0	4.4
Unemployment Rate a/ (percent)									
CBO	9.7	10.6	9.8	9.0	8.4	8.0	7.5		
Administration	9.7	10.9	10.0	9.0	8.2	7.4	6.6		
Three-Month Treasury-Bill Rate (percent)									
CBO	10.6	6.8	7.4	7.2	6.6	6.1	5.9		
Administration	10.7	8.0	7.9	7.4	6.8	6.5	6.1		

a/ Excludes uniformed military personnel.

and current spending policies (see Figure 1). This is the same budget outlook seen last year at this time, but the magnitude of the deficit problem has increased, despite actions taken by the 97th Congress to reduce spending and increase revenues.

Figure 1.
CBO Baseline Budget Projections



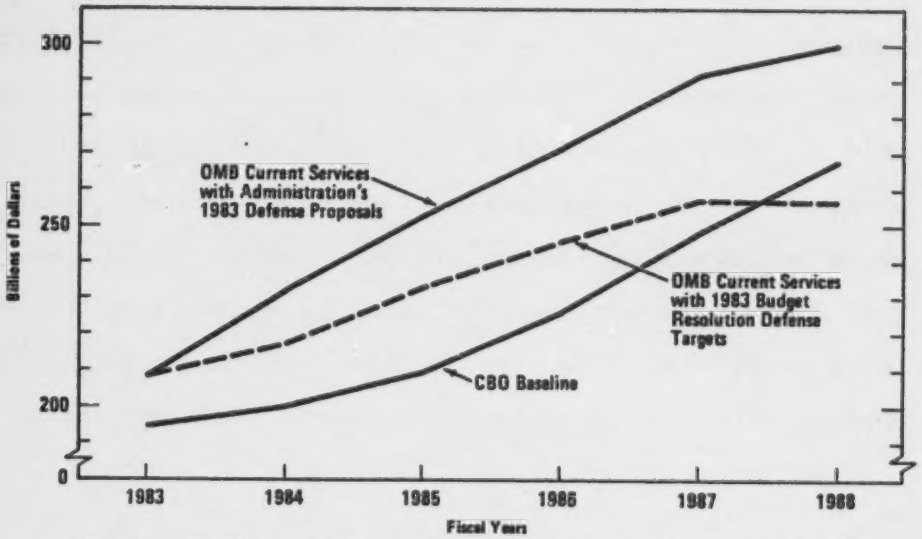
The primary reason why the budget deficit problem is worse now is the poor performance of the economy last year. As a result, the budget deficit for 1983 is currently expected to be about $195 billion--almost double the $104 billion target the Congress set last year in its budget resolution. CBO estimates that federal revenues will be $606 billion in 1983, $12 billion below the amount collected in 1982 and $60 billion below the budget resolution target. Federal outlays in 1983, on the basis of actions taken by the 97th Congress, are now estimated to total about $800 billion, or $30 billion more than projected by last year's budget resolution. Most of this rise is the result of higher costs for unemployment benefits and farm price supports and lower Outer Continental Shelf (OCS) receipts.

Revenues are projected, under existing laws, to resume their growth as the economy recovers, but the growth in revenues is projected to be slightly slower than the growth in the economy. As a consequence, CBO projects revenues as a percentage of GNP to be only 18.4 percent in 1988--well below the post-World War II high reached in 1981 of 20.9 percent of GNP. The main reason for the decline in revenues relative to GNP over the 1984-1988 projection period is the large tax reductions enacted in the Economic Recovery Tax Act of 1981 (ERTA)--reductions that were only partly offset by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Under CBO's current policy assumptions, federal outlays are projected to grow about as fast as revenues, increasing to more than $1.1 trillion by 1988. Relative to GNP, projected outlays would decline slowly from 25.0 percent in 1983--the highest ratio since World War II--to 24.0 percent in 1988, a ratio still higher than for all the postwar years before 1982. More than 90 percent of the projected $350 billion in outlay growth is concentrated in just four areas: national defense, Social Security, Medicare and Medicaid, and net interest costs. These four components will account for 68 percent of total outlays in 1983 and 75 percent of total outlays by 1988 under CBO's current policy assumptions.

CBO projections show that, if no changes are made in tax laws and spending policies, the budget deficit would rise to about $200 billion in 1984 and then grow gradually to nearly $270 billion by 1988. The "current services" projections by the Office of Management and Budget (OMB) also show rising budget deficits over the next five years under current policies (see Figure 2). Actually, OMB's budget deficit projections are higher than CBO's, but about 60 percent of these higher deficits result from different definitions of current policy for national defense programs.

Figure 2.
Federal Budget Deficit Under Current Policies



SOURCES: *Budget of the United States Government, Fiscal Year 1984;* and Congressional Budget Office.

OMB's current services projection uses the Administration's defense spending proposals in the 1983 budget as the definition of current policy for 1984-1988. The CBO baseline projections use the defense spending targets in last year's budget resolution for 1984 and 1985 and extrapolate these targets to 1988. The cumulative five-year difference between the two current policy projections of national defense outlays is about $120 billion. If the same national defense spending assumptions were used, however, the two deficit projections would be much closer.

THE ADMINISTRATION'S BUDGETARY PROPOSALS

The President's 1984 budget spells out a plan for reducing the budget deficit over the next five years. If this plan were adopted, the Administration estimates that the deficit would be sharply reduced from a current policy level, but it still would exceed $100 billion by 1988.

How to characterize the President's plan depends upon what baseline is used as a starting point. The Administration describes its deficit reduction plan as amounting to more than $550 billion over the 1984-1988 period, with reduced spending accounting for nearly 60 percent of the lower deficits. These spending reductions would include $47 billion of lower defense outlays over the next five years. Nondefense program outlays would be cut by $201 billion, and net interest cost savings resulting from lower deficits would account for another $76 billion. The remaining $234 billion in deficit reductions would come from increased revenues, with the contingency tax proposals accounting for $146 billion (more than 60 percent of the revenue increase).

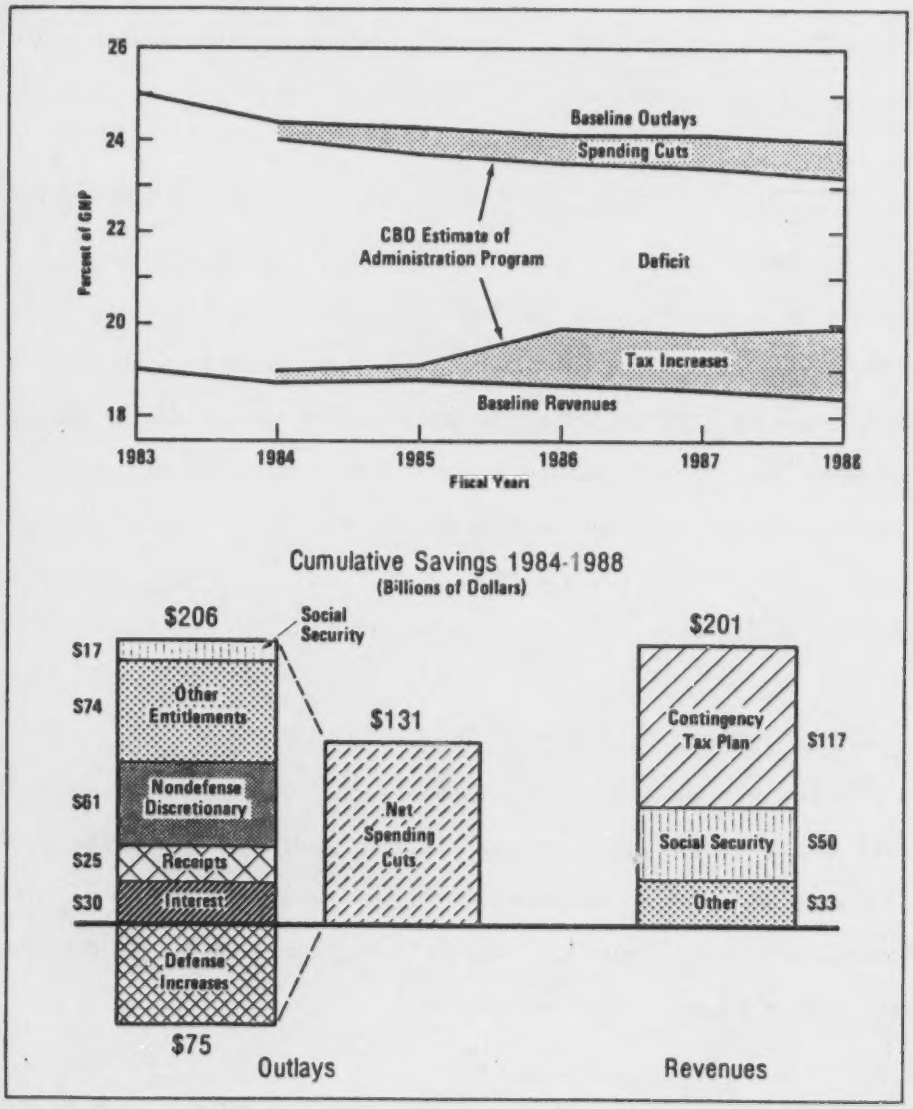
Using CBO's baseline projections as a starting point, however, gives a different cast to the Administration's deficit reduction plan. Instead of a reduction in defense spending, the President's 1984 budget would result in a $75 billion increase in national defense outlays over the next five years relative to CBO's baseline projections. Outlays for nondefense programs would be cut by $176 billion, and net interest costs would be reduced by only $30 billion. Relative to CBO's baseline projections, total outlays would be lowered by $131 billion over the 1984-1988 period. CBO estimates that the Administration's tax proposals would add $201 billion to the projected five-year revenue stream. The total deficit reductions would accumulate to $332 billion by 1988.

The Administration's budget plan relative to CBO's baseline projections is depicted in Figure 3. Under CBO's estimates (which I will describe in more detail later), the budget deficit would be reduced to about $150 billion by 1986 and remain at approximately this level for the next two years. As a share of GNP, the budget deficit would fall steadily from 6.1

percent in 1983 to 3.3 percent by 1988. This would be slightly higher than the Administration's estimate of 2.6 percent of GNP.

The Administration's 1984 budget includes the recommendations of the National Commission on Social Security Reform to provide solvency to

Figure 3.
Administration's Budget Program



SOURCE: Congressional Budget Office.

the Social Security retirement trust fund (Old Age and Survivors Insurance). The effects of the commission's proposals would be to add $50 billion to unified budget revenues during 1984-1988 and to reduce outlays by $17 billion. Spending for other entitlement programs would be cut by an estimated $74 billion, of which the largest portion ($29 billion) would be in the Medicare and Medicaid programs. Under the Administration's proposals, outlays for Medicare and other entitlements (excluding Social Security benefits) would still rise from an estimated $221 billion in 1983 to about $270 billion by 1988, but their projected growth under CBO's baseline would be cut nearly in half.

Nondefense discretionary programs also would be cut back significantly from current policy levels. Outlays for these programs, which will amount to about $145 billion in 1983, would be cut by $61 billion during 1984-1988. Relative to CBO's baseline projections, which allow spending to keep pace with inflation, this represents a 50 percent reduction in the projected growth of nondefense discretionary outlays over the next five years. Under the Administration's plan, outlays for nondefense discretionary programs would increase to $163 billion by 1988, but they would fall relative to GNP from 4.5 percent in 1983 to 3.4 percent.

CBO REESTIMATES OF THE PRESIDENT'S BUDGET

In CBO's analysis of the President's 1984 budget, we have repriced the Administration's revenue and spending projections using our own economic assumptions and technical estimating methods. Last year, this process produced a dramatic change for the projected budget deficits, showing rising instead of declining deficits.

This year, we do not have major estimating differences with the Administration. Our economic assumptions, while not identical, are fairly

similar. The effects of CBO's slightly more optimistic assumptions for the near term would mean a somewhat lower deficit under the Administration's budget proposals during the next few years (see Table 3). By 1987, however, use of CBO's economic assumptions would result in somewhat higher deficits, largely because of lower revenues.

TABLE 3. THE BUDGET OUTLOOK UNDER ADMINISTRATION POLICIES (By fiscal year, in billions of dollars)

	1983	1984	1985	1986	1987	1988
Revenues						
Administration estimate	598	660	724	842	916	1,010
CBO estimate	606	664	728	826	884	954
Outlays						
Administration estimate	805	848	918	990	1,058	1,127
CBO estimate	801	840	905	973	1,044	1,113
Deficit						
Administration estimate	208	189	194	148	142	117
CBO estimate	195	176	177	147	160	159
Differences in Projections						
Revenues						
Economic	--	2	3	-7	-21	-40
Technical	9	3	1	-10	-12	-17
Total	9	5	4	-16	-33	-57
Outlays						
Economic	-2	-9	-10	-11	-12	-14
Technical	-2	1	-4	-6	-2	*
Total	-4	-8	-13	-17	-14	-14
Deficit						
Economic	-2	-11	-13	-4	9	26
Technical	-11	-2	-5	4	9	17
Total	-13	-13	-18	*	18	43

* Less than $500 million.

The largest CBO technical reestimate involves the Administration's proposal for a temporary contingency excise tax on oil, both domestically produced and imported. Although the budget specifies a $5 per barrel tax, the revenue estimates are based on a $7 per barrel tax. CBO estimates that the $5 tax would raise approximately $9 billion less per year than reported

in the budget, or $27 billion less over the duration of the tax (1986-1988). CBO has made a number of other technical reestimates in both revenues and outlays, but they are rather small in the aggregate.

Overall, the CBO reestimates suggest that the budget deficits in 1983-1985 would be somewhat lower than the Administration projects assuming its budget proposals were adopted. For 1987-1988, on the other hand, CBO projects somewhat higher deficits under the Administration's plan. The estimating differences are slight, however; they remain well within the range of estimating error--particularly if the experience of the last several years is any guide.

CONCLUSION

It is now widely agreed that further actions are necessary to reduce projected budget deficits. Given the composition and dynamics of the federal budget, these actions will have to include both spending cuts and tax increases. Under current economic conditions, to avoid adverse effects on the economic recovery, it may be desirable to delay implementing major spending cuts and tax increases for a while. But as the recovery gathers momentum, the budget deficit will have to be reduced in order to ease federal borrowing demands and permit increased private investment.

A reasonable target would be to reduce the budget deficit to between 1 and 3 percent of GNP by 1988. The Administration has submitted one plan for moving toward this goal. During the next several weeks, the Congress will be considering this and other plans for reducing the federal deficit. To aid in this process, CBO has laid out a wide range of possible strategies and options in the third part of our annual report issued last week. We would be pleased to assist the Committee in any other way that we can as it considers various approaches to reducing the projected growth in federal spending.

THE DEFENSE BASELINE

Senator RUDMAN. Thank you very much. I believe the question that I had asked you during your testimony about the different assumptions and baselines on the defense numbers come from the fact that the administration is, in fact, using January 1982 numbers, which are numbers that you assume they were using. Your numbers come from the June 1982 budget resolution to Congress.

Ms. RIVLIN. That is correct.

Senator RUDMAN. Whereas the administration did, if you recall, in January 1983, present numbers which showed a reduction from that 1982 trend line, but you are still using the 1982 numbers because those are the numbers that they had presented as their policy.

Ms. RIVLIN. Our definition of baseline is the spending and taxing policies that were in effect at the end of the second session of the 97th Congress. For defense spending, our baseline figures derive from the congressional budget resolution for fiscal year 1983.

Senator RUDMAN. Right. Right.

Ms. RIVLIN. What we are trying to do for you is show how much the administration's new numbers differ from our baseline numbers.

Senator RUDMAN. Right. I have just a few questions. Thank you very much for that very good statement and excellent explanation on the differences.

AREAS OF GROWTH

Looking at your statement, you had on one page pointed out that about 90 percent of the growth came in a number of areas, medicaid, medicare, defense, social security.

Ms. RIVLIN. And interest payments.

Senator RUDMAN. That, of course, is in a section of your statement entitled "Current Policies." Obviously, those calculations do not include an assumption on what the Congress may or may not do with the Social Security Commission's recommendations.

Ms. RIVLIN. That is right.

The Social Security Commission's recommendations are incorporated in the President's budget proposals, but they are not included in our baseline, which shows how much growth there would be under current law.

Senator RUDMAN. I understand.

Ms. RIVLIN. May I continue that point for just a minute?

The other point to keep in mind, which is pointed out in my statement, is that the Commission's proposals, while they go to solving the social security problem, don't go a long way to solving the deficit problem. They particularly do not cut outlays very much in the Federal budget as a whole. The outlay reductions relative to current policy would only be about $17 billion over the whole 1984–88 period.

SIZE OF THE DEFICIT

Senator RUDMAN. You are, I am sure, familiar, as we are, with the recent highly publicized proposal by a group of very prominent Americans, former administration officials and the Secretaries of the

Treasury, and so forth. They argue that the plan to reduce these deficits by fiscal year 1985 to $194 billion is not sufficient. They believe a reduction to about $75 billion is required to restore confidence in this economy and to assure a sustained recovery.

I wonder how you react to that proposal, which I am sure you looked at in some detail.

Ms. RIVLIN. I think the proposal reflects that those people understand the problem very well and have the same level of concern about the outyear deficits that I think we all have, and that CBO has emphasized in its annual report. They also have focused, clearly, upon what the growth items are—defense and entitlements.

As to the exact target for deficit reduction, I think one can argue this in different ways. We have suggested in our reports as a sort of rough rule of thumb that it would be useful to get the deficit down to 2 percent of the gross national product by 1988. That is a fairly arbitrary number, but it would give you about a $100 billion deficit in 1988. That is a little more than the President is now proposing.

Senator RUDMAN. On that point, we hear many arguments and debates about the size of the deficit, the size of the national debt. In terms of assessing the burdens of these deficits and the accumulated debt put on this economy, which method of defining this do you prefer? Do you prefer the deficit as a percentage of GNP, or do you prefer the debt as a percentage of GNP? Which, more accurately, reflects the burden that these deficits are placing on the economy, in your view?

Ms. RIVLIN. There are several kinds of burdens, but I prefer to emphasize—as you were emphasizing in your conversation with Dr. Feldstein—the deficits as a percentage of anticipated gross national product. I think that dramatizes the problem most clearly.

Under our figures, if you don't change the policy, the outyear deficits will remain at roughly 6 percent of the gross national product. The reason to be concerned about these large outyear deficits is that they will use up very large proportions of national saving and will crowd out private investment. It is for that reason that I think that deficit as a percent of GNP is a very significant number.

On the other hand, the debt related to GNP is also significant. To a great extent, it gives you another measure of the same problem. If the Federal debt is increasing faster than the gross national product, as it is at the moment, then it essentially means the same thing—that the Federal Government is using much of the net increase in savings just to finance the deficit rather than to expand private investment.

INTEREST RATES

Senator RUDMAN. Dr. Rivlin, one final question before I turn it over to Senator Stennis. That is this: Most people who have testified before the committee and most writings on the subject recently indicate that unless interest rates come down another 1½ to 2 or 2½ points on the prime we will probably not be able to have a sustained recovery.

Do you share that view?

Ms. RIVLIN. Yes; I wouldn't give it an exact number. Our forecast, which does project recovery, assumes that interest rates will come down some more this year, and we do think that is important. Even more important, I think, for the sustainability of the recovery is that interest rates not shoot up again as the recovery takes place.

That, again, gets us back to the same thing about the deficit.

Senator RUDMAN. That is where I was heading, obviously.

The second part of the question, of course, is that it is generally conventional wisdom around here that unless we are able to make deficit reductions greater than the President had set forth in his budget message, then, in fact, the artificially high interest rates that Dr. Feldstein was speaking about would probably stay that way because of the lack of confidence in financial markets of what our long-term deficit projections are going to be.

Ms. RIVLIN. I think that is right. But not to sell the President short, he is proposing quite substantial reductions in the deficit, from levels that would otherwise be nearly 6 percent by 1988 down to 3 percent. If you could get it down to 2 percent, that would be even better.

Senator RUDMAN. Thank you.

Senator Stennis?

Senator STENNIS. Dr. Rivlin, I am going to be brief of necessity here because of your situation, but I remarked that I had set out to be somewhat more active on the Appropriations Committee.

One of my reasons was that I wanted to get into a position where I could hear your testimony more often. Now I am met with the fact that you are leaving, I hope not through despair. [Laughter.]

Ms. RIVLIN. Not at all, and I am not leaving the city, Senator. I would be glad to talk with you anytime you want.

Senator STENNIS. That is encouraging.

Senator RUDMAN. It will cost more. [Laughter.]

CONCERN ABOUT HIGH DEFICITS

Senator STENNIS. You used that word concern frequently, and that describes it to me fairly well. I claim to be rather close to the people. I think that describes the people's state of mind better than anything else, not fear in their minds as much as it is concern.

That is an honest concern. There is more and more confusion brought in. I am not referring to your testimony, but do you have a figure in your mind, expert that you are, and you are an expert; do you have a figure in your mind as to the amount of reductions that will have to be made, I mean, in the outyears, by the Congress to bring about this desirable state to which you and others refer of getting to reducing the deficit? I mean, reducing the large deficit and by what year?

Do you have something in mind that you could give us as a firm recommendation that we could work to?

Ms. RIVLIN. We certainly have illustrations of approximate magnitudes to which we think the deficit ought to be brought down. There

is no exact number; nobody knows exactly what the number ought to be.

Senator STENNIS. No; I know that.

Ms. RIVLIN. But as a rule of thumb, we have been using the prospect of getting the deficit down to 2 percent of the gross national product by 1988. That would be a deficit of about $100 billion in that year.

Senator STENNIS. By 1988?

Ms. RIVLIN. In 1988.

Senator STENNIS. In 1988.

Ms. RIVLIN. That would mean, still, about a $100 billion deficit in 1988, but it would mean a reduction from our baseline deficit—that is, what we think the deficit would otherwise be—of about $170 billion. That would be below what the President is proposing by about $60 billion.

Senator STENNIS. $100 billion sounds mighty big to me, and I have been working a good while in these high figures, but people generally were concerned in 1980, an election year, we got stirred up terribly about a much lower deficit than that. What was it in that year, 1980?

Ms. RIVLIN. About $60 billion.

Senator STENNIS. $60 billion is the figure; $60 billion, I remember.

Now, I frankly think, unless we can say something rather encouraging to the people, that they are going to be really upset and discouraged, positively, with reference to the level of this deficit. I just think of it as a practical matter.

Did you say that even though we follow your recommendations as to what to do we would still have a $100 billion deficit?

Ms. RIVLIN. That's right. That does sound like a very large amount of money, but it is approximately comparable relative to the size of the economy to the deficit we had in 1981, namely, about 2 percent of the gross national product. It's essentially going back to that level.

Senator STENNIS. Yes; well, I frankly am trying to think in terms of what the people see in these matters. They look at that large figure, I think, which is a deficit without surfeiting too much to GNP.

Ms. RIVLIN. It is not a number most people carry around in their mind.

SOCIAL SECURITY PROPOSALS

Senator STENNIS. I don't really grasp that every time myself. It seems to me I want to do something about these matters and we have got to get a better understanding on the part of the people as to just what we are doing and why we have to do it and that they are going to be better off with our action even though it may sting some at the time. They have to understand they will be better off and on a better foundation eventually.

That is what I think the duty of the Congress and the President, too, is to the people. I don't want to anticipate anything too much, but are you prepared to give a judgment about these so-called recommendations of the Social Security Commission and all the problems with it? Have you testified on that? If you have, I missed it.

Ms. RIVLIN. I have not testified since the Commission made its report.

Senator STENNIS. No; well, I won't anticipate someone else's testimony. There are going to be hearings on that right away by the Commission itself.

Senator RUDMAN. I think before the Finance Committee.

Senator STENNIS. By the Commission itself?

Senator RUDMAN. I think so.

Senator STENNIS. It seems to me like they ought to be heard first, frankly.

Ms. RIVLIN. Fine.

Senator STENNIS. Anyway, if you are still around, I want to talk to you about that.

Ms. RIVLIN. I would be delighted to.

Senator STENNIS. I didn't vote for the benefits anyway, nevertheless, they are here, and I can't stand a vote now on something that we think is a better plan than what we have.

Ms. RIVLIN. The problem clearly has to be solved, and the Commission has worked very hard to produce a solution.

Senator STENNIS. Yes; it's a plan and a foundation and a new start is what we need, isn't it?

Ms. RIVLIN. Yes.

Senator STENNIS. All right. That's all.

Senator RUDMAN. Thank you, Senator Stennis.

Doctor Rivlin, we deeply appreciate your coming up on behalf of Chairman Hatfield.

SUBMITTED QUESTIONS

Senator STENNIS. I do have some questions for the record.

Senator RUDMAN. Senator Stennis will submit some questions for the record. We will keep the record open for 5 days to answer them. Will that be sufficient time?

Ms. RIVLIN. I don't know what the questions are, but we will endeavor to answer them.

Senator RUDMAN. We will keep it open for 7 days for answers.

Senator STENNIS. They are in line with the general questioning.

Ms. RIVLIN. Fine. If there is anything else we can do for the committee, just let us know.

[The following questions were not asked at the hearing but were submitted to the department for response subsequent to the hearing:]

QUESTIONS OF CHAIRMAN HATFIELD

Question: In recent years the American economy has been in a period of starts and stops, with 2 recessions alone since 1980. Is a healthy, long-lasting period of recovery attainable now, or are we doomed to further short term ups and downs?

Answer: I do not believe that we will be doomed to a long period of stop-go economic performance, although that is certainly a possibility. The CBO short-run forecast represents our best judgment, and it shows real growth of 4.0 percent from the fourth quarter of 1982 to the fourth quarter of 1983, and 4.7 percent in the next year. That would be a mild recovery by comparison with previous recoveries, but not characteristic of a "stop-go" economy. Further out, CBO projections are not a forecast but merely assumptions about attainable average growth and price performance.

Admittedly, it will be very difficult to achieve a sustained economic recovery—long enough to reach more normal levels of unemployment and capacity utilization. Perhaps the most difficult challenge pertains to the design of monetary and fiscal policies. There is the risk that monetary policy will not be able to achieve the smooth growth recovery that is being sought. Monetary policy is a fairly blunt policy instrument, operating on the real economy with lags and in ways that are not fully understood. In addition, recent experience has shown that the demand for money sometimes shifts substantially for reasons that are not well understood—and that also complicates the task of monetary policy. Finally, current fiscal policy, involving a large structural budget deficit, greatly complicates the task of monetary policy. It is by no means certain that, over the longer term, the Federal Reserve will be able to achieve moderate and sustained growth in the face of continued large budget deficits and a resumption of stronger private credit demands. Thus, there are a number of uncertainties in the outlook, that could result in a stop-go pattern of growth; but it is assumed that they can be avoided.

Question: Given a major sustained reduction in the price of imported oil, what would be its effect on the recovery and on employment? How long before the effect will be noticeable?

Answer: In CBO's view, a sizable and permanent decline in oil prices would have a very favorable effect on the U.S. economy and would strengthen the recovery. CBO's estimates indicate that by 1988 the level of real GNP would be about 1½ percent higher, the price level (Consumer Price Index) about 2 percent lower, and the unemployment rate about one-half percentage point lower as a result of a permanent $6 per barrel reduction in oil prices from those assumed in the CBO baseline. The effect on unemployment would be felt gradually, but by 1984 the unemployment rate could average about 0.3 percentage point lower—a notable effect. However, there is great uncertainty about both the magnitude and the duration of the decline in oil prices, and therefore about its economic effects. The effects on the economy of a temporary decline in oil prices that is quickly reversed would be quite small. In addition, the effect of any decline in oil prices would be strongly influenced by the course of monetary policy.

Question: Interest rates reacted quickly to the initial easing of credit by the Federal Reserve, but did not seem to continue to respond as the Fed continued to drop the discount rate. Why didn't rates continue to decline? Was it the fear of the projected federal deficits? What does this tell us for future Fed policy?

Answer: Interest rates declined in the second half of 1982 in response to an easing of monetary policy, measures to reduce the deficit, international capital flows, and the prospect that the recession would be longer. The decline in short-term rates was more rapid than the decline in longer-term rates but more short-lived, with bill rates reaching the 8 percent level in September and remaining in that range through the current period. However, long-term rates fell slowly from their mid-year levels and continue to edge downward. Fears about prospective federal deficits as well as uncertainty about the future course of monetary policy undoubtedly contributed to the slowing in the interest rate decline. Thus, despite favorable news on inflation, interest rates remain high by historical standards for this point in the business cycle.

Periodically during the second half of last year, the Federal Reserve lowered the discount rate in order to realign it with other falling short-term market rates and avoid choking off further declines. However, the final discount rate cut in 1982—one that was widely interpreted as an attempt to actively push rates down further rather than as merely a passive realignment—was met with a rise in short-term rates. Apparently, market uncertainty over the course of monetary policy and the effects of the rapid growth in the money supply since last summer had resurrected fears of inflation and prompted the markets to adopt a wait-and-see attitude.

In recent testimony before the Senate Banking Committee, the Federal Reserve reaffirmed its commitment to provide sufficient credit to sustain a moderate recovery. The targets for the monetary aggregates were—after adjusting for institutional changes—about the same or slightly lower than last year. This policy, which is essentially what was assumed by CBO in preparing its economic forecast, will likely contribute to modest economic growth and somewhat lower interest rates. After the market reaction to the December discount rate cut, the Federal Reserve is likely to be more cautious in attempting to push rates down further.

Question: Some economists have argued that the Federal Reserve can relax monetary controls for a lengthy period without retriggering inflation, because of the depressed state of the economy. How long do you believe we can permit money to expand at the rates seen in the last half of 1982 without an inflationary spiral?

Answer: The rates of money growth observed in late 1982 were only permitted because of an unusual circumstance, a decline in money velocity--the first such decline in nearly 30 years. Had velocity not been declining, these rates of money growth would have been excessive. Most analysts expect velocity to begin growing again within the next several months, as the economic recovery gets underway. If this happens, the growth of the money supply will need to be reduced to avoid creating inflationary pressures. The Federal Reserve is monitoring the course of velocity closely and has indicated that it will set money growth rates accordingly.

Question: In a recent article, Murray Weidenbaum argued that there is a national security argument in favor of slowing the rapid growth of military procurement. He argues that weapons programs with large cost overruns are those whose unit volumes are cut in time of budgetary constraints, while those without large overruns are not as often cut back. His conclusion from his data was "slowing the growth rate of defense spending to conform more closely with production capabilities will both reduce the deficit and make

more likely the successful completion of the military buildup." What is your reaction to this theory?

Answer: It may be that weapons programs showing large cost overruns tend to get cut back disproportionately, in terms of unit volume, when budget constraints are tight. However, bottlenecks are just one cause of weapons cost growth, and perhaps not the most important one. Indeed, there are important situations in which reducing the number of weapons purchased may actually increase unit prices. The data cited by Professor Weidenbaum, in fact, illustrate how sharp cuts in quantities can result in large increases in the unit costs of weapons. In addition, capacity constraints are currently not widespread. Many industries, even many of those specializing in defense production, are currently depressed and have the capacity of doing more defense work. As time passes and both private and defense spending rises, capacity may grow tighter. Thus, a postponement of some near-term defense purchases to 1985 and beyond could actually increase the risk of bottlenecks.

I think we need to assess both the potential benefits and the costs of the proposed defense buildup and, if that assessment indicates defense is to be cut, then we need to do it in a way that makes efficient procurement likely. That probably means some hard decisions to terminate, or postpone buying, some weapons so that others can be bought at efficient rates.

Question: January unemployment rates have traditionally been unreliable. Many professional economists discount the January figures unless they are part of a trend. Was the official drop in the January unemployment figures really a good reflection of conditions in the employment market? Do you expect to see the unemployment rates continue to drop significantly?

Answer: The sharp decline in the unemployment rate between December and January was not an adequate reflection of changes in labor market conditions. It is especially difficult to interpret the employment situation during the winter months, because of the influence of weather and because of the importance of the Christmas season for retail sales. The January Employment Situation release illustrates these difficulties: Employment, as measured by the household survey, was basically unchanged in January. Nonagricultural payroll employment, which is based on employers' reports, was up sharply by 340,000 from the December 1982 level. However, the gains in payroll employment were concentrated in retail trade (up 240,000) and construction (up 115,000)—both of which are strongly affected by seasonal factors. In this case, construction employment was boosted by unseasonably mild weather. In retail trade, hiring for the Christmas season had been relatively light in November and December. Thus, the "improvement" in retail trade employment from December to January was probably overstated substantially by the official measure.

The average length of the workweek—an important leading indicator of the labor market—did show some improvement in January from December. But seasonal factors may also have led to some distortions in this series. The data for February suggest that may have been the case, because the average workweek declined—more than offsetting the increase of the previous month. (However, the February data may have been biased in the opposite direction because of snowstorms.)

The CBO forecast shows the unemployment rate continuing at very high levels in 1983, and then edging downward to about 9.8 percent for

calendar year 1984. The basic reason for the slow decline is that the recovery is expected to be moderate by historical standards. (During recoveries, it takes substantial growth in output to reduce unemployment because of cyclical recovery in the size of the labor force, in hours worked per week, and in labor productivity.)

Question: CBO's forecast for average unemployment for 1983 is 10.6 percent, the same as the Administration's. After release of the January figures, do you believe this figure may have been too pessimistic?

Answer: No, the recent evidence on the employment situation has not been that clear-cut. Virtually all of the decline in the unemployment rate from December to January was accounted for by a drop in the labor force, rather than an increase in employment. Most of the decline in the labor force was accounted for by adult, white males; and the causes of such fluctuations in the labor force are simply not well understood. Month-to-month movements in the labor force and in unemployment statistics are quite volatile; and, as a consequence, it is too early to tell whether the January data imply a meaningful change in the outlook. The same thing holds for the February data, which showed unemployment, employment, and the labor force basically unchanged from January levels.

Question: Unemployment figures have been on an adverse trend ever since 1970. The average unemployment in the 1960s was 4.8 percent; for the first half of the 1970s it was 5.4 percent; for the last half of the seventies it was 7.0 percent; and thus far in the 1980s it has averaged 8.1 percent. This time frame is long enough to factor out recessionary periods. Recovery from recession brings improvement, but not all the way back to previous levels. Why? Do we face worse and worse statistics in the future, or is there reason to think we can turn this around?

Answer: The upward drift in unemployment rates has been the result of a combination of factors. Many economists believe that the underlying rate of unemployment, or the lowest unemployment rate that does not contribute to accelerating inflation, has increased from 4 to 5 percent in the mid-1950s to something like 5½ to 6½ percent in recent years. Among those factors that are believed to contribute to the increase in the underlying rate of unemployment are demographic changes in the labor force and increases in income transfers from the government and from other employed family members. In addition, the oil price shocks in 1974 and again in 1979-1980 contributed to higher unemployment, especially after the Federal Reserve began focusing on the control of money aggregates in late 1979 as a way of reducing inflation.

As to the future, most economic forecasters expect unemployment to decline very slowly from recent high levels because the economic recovery is expected to be mild by historical standards. For example, the CBO forecast shows unemployment averaging 9.8 percent in 1984. However, over the longer term there are reasons to be hopeful that the upward drift in unemployment will not continue and may be reversed. One reason is that demographic trends may contribute toward a gradual reduction in unemployment, as the proportion of youths in the population declines in the years ahead. A second reason for optimism is that, while it cannot be ruled out, another major upward price shock from OPEC does not appear imminent. Yet another reason for optimism is that structural measures, such as training and worker adjustment assistance, can perhaps play a significant role in reducing unemployment over a period of years.

Question: Estimates of the cyclical and structural components of future budget deficits are dependent on a large number of assumptions, so differences are to be expected. The table on page 2-18 of the budget document, "High-Employment Deficit," provides figures for 1983 and 1984 that apparently suggest that the structural component of the deficit is very large in relation to the total deficit, over two-thirds in 1983 and almost three-fourths in 1984. Most other estimates, including those of CBO, attribute larger importance to the cyclical components in 1983 and 1984. Could you explain what may have caused the difference between the Budget document and those other estimates?

Answer: The reasons why OMB attributes a much larger proportion of the 1983 and 1984 deficits to structural factors than does CBO can be summarized as follows: First, the Office of Management and Budget (OMB) has adopted a lower level of cyclically adjusted or "potential" GNP than that used by CBO to determine the structural component of the deficit. This lower standard or benchmark implies less economic slack, even though OMB has a somewhat lower forecast of real GNP. The effect of assuming less economic slack raises OMB's estimate of the structural deficit by $15 billion in 1983 and by $9 billion in 1984, according to CBO calculations. Second, OMB has made different policy assumptions (mainly higher defense spending) and employs different technical procedures than those used by CBO to estimate both the budget deficit and its structural component. These differences increase OMB's structural deficit by $51 billion in 1983 and by $58 billion in 1984. Finally, OMB's estimates of the structural deficit include off-budget outlays, whereas CBO's do not. This difference adds $16 billion to OMB's estimate in 1983 and $18 billion in 1984.

QUESTIONS OF SENATOR STENNIS

Question: Mrs. Rivlin, total federal debt first exceeded $1 trillion in 1981. OMB forecasts that debt to rise to $1.38 trillion in FY 84 and to $1.98 trillion in FY 88. During the 1970's decade, debt was 35-40% of total GNP. OMB forecasts it will grow to 46% of GNP in FY 84 and to 50% of GNP by FY 88, under the Administration Budget Plan.

What is your view of the impact that this steadily growing and large debt will have on our economy?

Answer: The large increase of federal debt projected throughout the recovery would increasingly crowd out net business investment, and may be having an adverse impact on current credit and economic conditions. The rapid growth of federal debt would absorb an extraordinarily large proportion of net private saving, and reduce the availability of funds at prevailing interest rates. As a result, credit would be more costly, and the growth of interest-sensitive business investment would be reduced—lowering gains in productivity and living standards. In addition, the large outyear deficits also may be impeding the start of the recovery. Expectations that future interest rates will be high because of large outyear federal credit demands may be contributing to currently high levels of real long-term interest rates. Thus, the projected growth of the federal debt may be limiting the current growth of sectors that are sensitive to real interest rates.

Question: Can we continue to pile up this debt at a faster rate than GNP is growing?

Answer: The projected rise in federal debt relative to GNP is not unprecedented. During the 1939-1946 period, the debt-GNP ratio climbed

from 46 percent to 128 percent. Thereafter, however, the ratio declined steadily to 35 percent of GNP in 1974 and reached a slightly lower postwar record in 1981.

Although the federal debt has in the past risen to much higher proportions of GNP than those currently projected by CBO or OMB, historical experience suggests that a continued increase could reduce the growth of nonfederal debt. During the postwar period, the sum of publicly-held federal debt plus nonfederal debt has been remarkably stable at approximately 140 percent of GNP. If this ratio remains fairly constant, the projected growth in federal debt would displace nonfederal debt relative to GNP. This reversal of postwar trends would jeopardize the prospects for increased capital accumulation and higher living standards in the longer run. Morever, as the federal debt grows relative to GNP, federal interest payments rise in relative importance, making it more difficult to reduce the growth of federal debt.

Question: What impact will this large debt have on interest rates for the future?

Answer: Financing this amount of Treasury debt will raise interest rates no matter how it is done. If the Federal Reserve does not help in the financing, the Treasury must offer high interest rates to persuade investors to absorb increasing amounts of debt. If the Federal Reserve tries to alleviate this problem by monetizing significant parts of the debt, interest rates may well rise anyway because of increasing inflationary expectations.

Question: Can the government expect to finance this debt without setting off another round of inflation?

Answer: Most analysts would argue that financing these deficits by issuing interest-bearing debt would not threaten a dramatic increase in inflation. Instead, it might cause stagnation in private investment and in productivity growth, leading to a relatively modest increase in inflation. If the Federal Reserve monetizes a significant amount of this debt, however, a stronger increase in inflation would eventually threaten.

Question: Mrs. Rivlin, what is the difference to the economy between financing government spending by taxes as compared to financing by debt borrowing? Is one way better?

Answer: Debt financing of government spending is likely to reduce private investment and thus to reduce productivity growth and living standards. Tax financing may also affect investment as well as labor supply, but its strongest effects may be in reducing consumer spending. If you want to promote investment rather than consumption, running large deficits is a mistake, and some increases in taxes may be a good idea. Which one is better thus depends on what you want to achieve.

QUESTIONS OF SENATOR LEAHY

Question: Nobel Prize winner James Tobin recently wrote that "Monetary stimulus can put the nation back to work and concurrently trim Federal deficits to manageable size. No other strategy can achieve these goals." Do you agree?

Answer: Professor Tobin represents one school of thought within the economics profession, holding that monetary stimulation would reduce short- and long-term interest rates and stimulate a stronger recovery, together with faster reductions in the deficit. Another line of argument holds, however, that monetary stimulus risks increasing long-term interest rates and aborting the recovery. This line of argument is plausible, and as a result, any move toward greater monetary stimulation should be made cautiously.

Question: What policy should the Federal Reserve follow if fuller recovery is to be achieved?

Answer: While reaffirming its commitment to support a modest recovery without rekindling inflationary expectations, the Federal Reserve recently announced money supply targets that—after adjustments for institutional changes—are about the same as last year's. Perhaps a more expansive monetary policy would promote a faster recovery; however, there is a risk that such a move would increase inflationary expectations leading to higher interest rates and a short-lived recovery. The announced policy should be sufficient to promote a modest sustainable recovery—assuming that velocity, or the relation between GNP and money, returns to a more normal growth rate.

Question: The Administration is proposing a very slow recovery. In 1984, there will still be four million more people unemployed than there were in 1979.

Is there a set of monetary and fiscal policies which could reduce unemployment more rapidly?

Answer: Since fiscal policy is already quite expansive under current policies, the primary question concerns the efficacy of using expansive monetary policy in an effort to reduce unemployment more rapidly. Given the large amount of slack, both in this country and abroad, a somewhat faster recovery, particularly in the first year or two, would probably not result in a large increase in inflation. There is still the risk, however, that inflation and nominal interest rates could be significantly increased in the longer run by such a strategy. To a considerable extent, then, policymakers are faced with a choice: emphasize the reduction of unemployment at some risk of inflation, or emphasize fighting inflation at the risk of continued high unemployment.

In the area of fiscal policy, further budget stimulus could generate tighter credit conditions unless offset by accommodative monetary policy. It would tend to crowd out investment and other interest-sensitive types of private spending. However, if the emphasis is to be on fighting inflation, efforts can nevertheless be made to reduce the hardship of unemployment. These could include extending unemployment insurance benefit periods and closing some of the gaps in the "safety net" for the unemployed. Targeted countercyclical programs might also be used to provide some employment opportunities, where they are most needed. Programs to alleviate hardship could be combined with longer-run measures to reduce structural unemployment, such as increased job training and assistance to workers in finding jobs.

Question: The President has stated that the economy has turned the corner. However, I am very disturbed that the projected recovery is so

weak. In 1984, there will be four million more people unemployed than there were in 1979.

I have noticed that real interest rates are several times higher than they were when recovery was beginning from other recessions. Would there be a stronger recovery if the Federal Reserve changed its monetary policies to lower real interest rates?

Answer: Using more expansive monetary policy to reduce real interest rates might succeed in stimulating a faster recovery and a faster decline in unemployment than we project. Given the large amount of slack, both in this country and abroad, a somewhat faster recovery might not result in a large increase in inflation. There is still the risk, however, that inflation and nominal interest rates would also be increased by such a move.

Question: In a recent article MIT economist Lester Thurow stated that "the economy is not dying a natural death—it is being murdered by its monetary policies." Do you believe monetary policies are the principal reason for the present recession and the very slow recovery?

Answer: While monetary policy was not solely responsible for the recession and for prolonging the recession, it was a contributing factor. By most measures, monetary policy became tighter after 1979 when the Federal Reserve began focusing more on restraining money growth as a means of fighting inflation. Tighter monetary policy together with a strong momentum of inflation has contributed to the overall sluggish performance of the economy since 1979. The current recession was prolonged in part by very tight credit conditions. Credit conditions tightened in early 1982 as a result of an unexpected increase in money demand (decline in velocity). Despite relatively rapid growth in the money stock in early 1982, this increase in the demand for money was only partially accommodated. As a result, interest rates remained high producing an unwanted inventory buildup that was not corrected until the fourth quarter of 1982. In addition, a high exchange rate led to a large reduction in net exports. Other factors contributing to the recession in 1982 were: worldwide recession, which reduced U.S. export markets, severe debt problems of some developing countries—the other major factor contributing to the high U.S. exchange rate and loss of exports—and large federal deficits expected in future years, which helped keep long-term interest rates high.

Recently the Federal Reserve has announced targets that it feels will accommodate a moderate sustained recovery without reigniting inflationary expectations. The success of this policy, however, will depend upon the behavior and predictability of money velocity (the relation between nominal GNP and money aggregates).

COMMITTEE RECESS

Senator RUDMAN. Thank you very much.

The committee is going to stay in recess until February 22 at 9:30, and we will hear from David Stockman, the Director of the Office of Management and Budget.

[Whereupon, at 11:15 am., Wednesday, February 16, the committee was recessed, to reconvene at 9:30 a.m., Tuesday, February 22.]

ECONOMIC OVERVIEW FOR FISCAL YEAR 1984

TUESDAY, FEBRUARY 22, 1983

U.S. SENATE,
COMMITTEE ON APPROPRIATIONS,
Washington, D.C.

The committee met at 9:30 a.m. in room SD–192, Everett McKinley Dirksen Senate Office Building, Hon. Ted Stevens presiding.

Present: Senators Stevens, McClure, Andrews, D'Amato, Rudman, Specter, Domenici, Stennis, Proxmire, and Huddleston.

OFFICE OF MANAGEMENT AND BUDGET

STATEMENT OF DAVID A. STOCKMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

OPENING REMARKS OF SENATOR STEVENS

Senator STEVENS. Good morning.

This is the last of our Economic Overview hearings for the year.

Last week the committee heard from Treasury Secretary Don Regan, from Dr. Martin Feldstein, Chairman of the Council of Economic Advisers, and from Dr. Alice Rivlin.

Today we are here to hear your comments, my good friend, as the Director of the Office of Management and Budget. Then we will hear from two distinguished nongovernmental economists, Dr. Alan Greenspan and Dr. George Perry, for their views and recommendations on our economic situation, and how it affects the work of this committee.

I first want to ask my good friend, John Stennis: Senator, do you have any comments?

Senator STENNIS. I am very glad to be at the hearing and I will have some questions.

Thank you.

Senator RUDMAN. I have no questions.

Senator STEVENS. It is nice to have you with us.

Mr. STOCKMAN. Thank you very much, Mr. Chairman. I have a rather complete document that highlights both the economic and larger fiscal issues in the budget, as well as focuses on specific concerns of this committee regarding the requests for appropriations that are pending before your committee.

At this time I would like to ask that this document be submitted for the record and if I could take about 5 minutes, I would like to call your

attention to certain highlights and pages in order to place some information of interest to the committee into the record.

Senator STEVENS. We will print that document at the conclusion of your remarks.

We appreciate your courtesy in highlighting it.

Mr. STOCKMAN. Thank you very much, Mr. Chairman.

HIGHLIGHTS OF THE BUDGET TOTALS

I ask you to look at page 1, which provides the budget aggregates. I think there are three important points underlying these large numbers regarding outlays, receipts, and deficits.

The first point is that we start very deeply in the hole regarding the deficit, $208 billion in 1983. This represents primarily the impact of the recession on the Federal budget during this current fiscal year. Because there has been no growth in receipts for the last 3 years, the receipts in 1983 will not be much higher than they were in 1981. Obviously, that results in significant deficits.

As you move into the outyears, however, two trends are apparent: (1) the cautious recovery that we are predicting for 1983 and the sustained 4-percent growth thereafter cause receipts to rise substantially in the outyears; and (2) the large program of deficit reduction contained in the President's budget, some $558 billion over the next 5 years, gradually closes that gap between receipts and outlays and brings the deficit down steadily both as a share of GNP and in overall dollar measures.

The second point that I would call your attention to is on page 3, which gives the overall outline—in terms of budget magnitudes—of the 4-point deficit reduction or freeze in the plan that we had proposed. As you can see, each of the segments in the overall deficit reduction strategy provide very large changes in the budget, increasing as you move into the outyears.

For these measures—both in discretionary programs, as well as in cost of living increases, and some of the other outlays in the budget—the deficit reduction will be $19 billion in 1984, rising to about $45 billion for 1988, for a total savings of $164 billion over the 5 years in the budget period.

You are aware of the defense changes, $47 billion in outlays over 5 years. The structural reforms primarily have their impact in the outyears. They include the social security package and the medical reform package, as well as some more modest changes in the civil service system and in the means-tested entitlements. I think the important point here is that the dollar impact starts relatively modestly at $19 billion a year in 1984, but by 1988 it reduces the deficit by $82 billion. This is clearly the largest and most important component of the overall plan to close the enormous gap between revenues and outlays.

Finally, the standby revenue measures effected in 1986 through 1988 would further reduce the deficit by $146 billion.

DESCRIPTION OF APPROPRIATED PORTION OF BUDGET

I know that this committee is primarily concerned with the appropriated part of the budget. I would like to call your attention to a few highlights of that part of the budget.

First, if you look at page 6, you will see that even though we are in a very difficult, almost unprecedented budget situation in terms of the size of the deficit that we face, both for policy and for economic reasons we feel that there are some areas where priorities are so important, where needs are so great, that substantial funding increases need to occur. Inasmuch as over the last 2 years we have talked almost entirely about cuts and reductions and savings and reform, I thought it would be useful this morning to call to the attention of the committee those areas where we feel—despite this enormous fiscal pressure—spending increases are warranted. This is only an illustrative list, but there are really four areas where we felt spending increases of some magnitude were needed.

In the area of science, both the National Science Foundation and basic research at DOE are up 18 and 21 percent respectively. In certain highly effective human resources programs, where we have clearly seen positive results from the programs involved, there are increases: Head start, college work study, and foster care being the three examples that we have provided here.

Finally, law enforcement is up 10 percent, reflecting an almost universal recognition of the need to increase our resources in this area. Spending for highways, airports and airways, and basic public infrastructure is also up by a large magnitude due to the measures we took last fall in user fee legislation for the airports and the air traffic control system.

Another thing I would like to point out to the committee is revealed very clearly on page 7. Given the enormous magnitude of this budget problem, it is important that we cooperate on the large things that need to be done in terms of reforming our entitlements, retirement, and medical entitlement programs, and capping the COLA's. In order to achieve cooperation on the major measures, which will affect in some significant way the near- and long-term budget posture, it seems to us important at this stage to reduce friction wherever possible on smaller dollar items in the budget where in the past there have been large differences between congressional sentiment—particularly attitudes on this committee—and the position of the administration.

So if you will look at this list of programs ranging from handicapped education to employment and training, rehabilitation services, and social service block grants, you will see that in 1983 the difference between what we requested and what you appropriated was $5 billion. We asked for $11 billion, you appropriated $16 billion.

While we still feel that some of the savings that we proposed in 1983 are justified, in recognition of the need for cooperation on the larger elements of the budget solution we have requested a funding level in 1984 nearly identical to what was appropriated in 1983 for these programs: some $16 billion.

PUBLIC INFRASTRUCTURE SPENDING

Again, this is an indication of another facet of the policy and the strategy involved in this budget, and that is minimizing the arguments and differences in small areas where congressional sentiment runs strong in order to obtain cooperation and bipartisan progress in the larger structural dimensions of the budget that need to be improved. I think this can be seen on page 9, where we have broken out of the budget the dollar levels for public infrastructure spending.

As you can see, this particular chart covers the whole range of public infrastructure investment that has become the responsibility of the Federal Government: Highways, airports, waste treatment plants, water resources, and community development grant programs.

I think the important story here is that over the last 2 years, as a result of the user fee legislation, Congress and the administration together have substantially increased the funding level for these basic investment programs in the national and local infrastructure of this country from $26 billion to $35 billion, or by more than one-third.

There is sometimes a complaint that we are not doing enough. I think this chart indicates that we have made enormous strides already and, in terms of the debate now going on about jobs, I think it is important to recognize that by making these funding increases, we have generated somewhere in the range of a quarter of a million jobs directly attributable to these higher levels of funding.

More importantly, we have done it in the fiscally responsible way. Nearly the entire increase displayed in this chart, from $26 to $35 billion for basic infrastructure, has been financed with user fees and therefore has not added to the deficit. It has been funded in a balanced way.

BUDGET SHARE OF GNP

In terms of the overall dimensions of the budget, I would call your attention to the chart on page 10. This simply indicates the overall dimension and direction of the plan for reducing the spending share of GNP from the historic high of 25 percent this year to about 23 percent by 1988, and for bringing revenues into the range of 20 to 20.5 percent of GNP, thereby substantially reducing the deficit.

I think the most important part of this chart is shown in the lower right-hand panel that indicates that if we can implement all of the measures contained in this budget either exactly as we have proposed, or with modifications that you might suggest or insist upon, we will do something very important: Steadily and substantially remove the Federal Government from the credit market and remove the Federal absorption of the net private savings that we need in this country to sustain economic growth.

As you can see from this chart, the Federal absorption to finance the deficit will decline from 94 percent of net private savings in 1984 to nearly a third by 1988. I think the point here is that for a year or two the economy can absorb a large amount of Federal borrowing, but on a multiple-year basis it cannot. To the extent that the Federal Government is absorbing private savings over the long run, we simply

will not be making the investments in plants, facilities, new technology, and new jobs that we need to sustain the recovery.

There are two other aspects of the overall budget dimensions that are important. One is shown on page 11. This indicates that if we can implement the whole set of measures, both the near-term freeze measures and the long-term structural reform or entitlement reform measures, we will have succeeded over the next 5 years in bringing about a historic reversal of the nondefense spending claim on our national economy.

If you look at this chart, you can see that from 1970 to 1981, the nondefense budget literally exploded. For nondefense program outlays, excluding net interest, the claim on GNP rose from 10 to nearly 16 percent in that decade.

If we can implement all of the measures contained in this budget, building on the start that has been made in the last two budget cycles, we can gradually reduce the nondefense claim on GNP slightly under 13 percent. We will be unable to get it back where it started in 1980 because the permanent commitments of the Federal budget have been increased and cannot be reversed in many areas. But nevertheless, the historic trend will have been reversed, and the burden of the entire nondefense portion of Federal Government relative to the national economy will decline rather substantially. I don't believe that there is any other major industrial democracy that has ever succeeded in reversing the domestic spending burden on the national economy to this extent.

CONTROLLABILITY OF BUDGET

I would like now to turn to section 2 and call your attention to a couple of points. Section 2 focuses specifically on our request before this committee for appropriated budget authority for 1984.

If you will look first at page 15, this provides the total figures for new budget authority divided into three categories: (1) The 10 domestic agency bills for which we are requesting $233 billion; (2) the defense and security bills—military construction, defense, and foreign operations—for which we are requesting $286 billion; and (3) a breakout in the center, which takes the request for the 10 domestic agency bills and removes the entitlements, which you must appropriate depending on what other committees do, and removes other permanent or mandatory spending before your committee. In both areas you have very little control over the actual dollar requirements in any given year.

If you strip those kinds of items out of the total request, excluding the defense and security bills, you can see that we are requesting $131.5 billion for discretionary nondefense programs, which is $1.4 billion more than was appropriated in 1983.

In the subsequent pages in this section, I shall explain how we get to this freeze at the $151 billion level. I think if I could very briefly go through this, it might be helpful in understanding our freeze concept and resolve some questions that you will have.

1984 BUDGET FREEZE

The first thing that has to come out of the $233 billion request for the 10 domestic agency bills is entitlements and mandatories. Your committee can do very little once the legislative committees have made a decision or have not made a decision to change the underlying statutory authorities. On page 18, we indicate that annually appropriated entitlement programs will require about $106 billion with the structural changes and the statutory reforms that we have proposed. When you add the defense retirement entitlement and other mandatories to that total, $128 billion—or fully one-fourth of the total request before this committee—is for entitlement and mandatory programs for which we have to look to the budget process and the legislative committees to make any changes.

Our view this year will be the same as it was last year. If the standing committees fail to make the statutory changes that we have recommended, we would ask the Appropriations Committee to appropriate whatever is estimated to be needed this summer to fund the permanent law entitlements. Obviously, that would not be counted against the Appropriations Committee, nor be viewed as any add-on to spending, but simply a failure of the legislative committees of jurisdiction to make the changes that we have requested.

PRO FORMA BUDGET AUTHORITY

So we begin by deducting that from the total before the committee. Then if you turn to page 20, there is another set of budget authority before the committee that really is pro forma in the sense that you appropriate for the Commodity Credit Corporation to liquidate losses, and you appropriate for the Farmers Home Administration revolving funds to liquidate losses, but the real policy control or spending control on these programs is based on the underlying legislation or on a loan limitation that is separate from the budget authority level.

One reason why the budget authority request for the 10 domestic agency bills is down is that the budget authority that we will need for these revolving funds declined sharply in 1984. If you will look at the table on page 20, you can see that we needed $26 billion to replenish losses in 1983. We will need only $11 billion in 1984. That doesn't change any program, benefit, subsidy, loan, or activity level. It simply indicates that the bookkeeping requirements this year will be far lower than they were last year. Most of this, of course, is due to the Commodity Credit Corporation, where we have had a massive historic high. The outlays for the CCC are estimated to be $18.2 billion in 1983. Of course, we see that situation improving in 1984 due to improved prices and the payment-in-kind program that we have proposed to reduce costs in that area. So again, this money can be deducted from the request before the committee.

Page 21 then sums up the impact of making these adjustments to the budget authority request before the committee. If you will look at the center of that chart to the ten domestic agency bills, our request is $233.8 billion as I have indicated. If you remove the entitlements, the

mandatories, and this pro forma budget authority for the CCC and like agencies, the remaining request that actually applies to programs funded on an annual basis—health, welfare, rural, and other types of programs—the request is $112 billion. That is slightly below last year. If you will then turn to page 22, the picture is made complete when we bring in those matters before the committee where, through obligation limitations or lending limitations, rather than through new budget authority, you can control the program activity.

You can see that with our recommended obligation limits for the various trust funds and social security administrative costs, we are requesting about $20 billion in spending for these programs. This is up nearly $3 billion from 1983. If you add that to the new budget authority for the annually funded discretionary programs, it reconciles to the total of $131 billion.

I thought that explanation would be helpful because we have had so many arguments in the past about what the actual numbers are, what the budget resolution provides, and what we have requested. Again, I would like to suggest to the committee this year that once the budget resolution is determined in aggregate amount of new budget authority and various obligation and lending limitations, we would like to be able to work with this committee to establish 302–b levels for each subcommittee. We can then use these allocations as benchmarks for assessing the measure of the appropriations bills as they come through later.

This is what we have in our budget request. I know that this committee may differ on the line item programs, but I think the idea of a freezing in the aggregate of $131.5 billion is something that makes sense, and is something that we ought to strive for in the budget resolution. We can then rely on this committee to find the best allocation and mix among the programs as we go through the process.

ANALYSIS BY APPROPRIATION BILL

In order to provide a little more information, beginning on page 25 I have broken down our request for each of the 10 domestic agency bills by stripping out the entitlement, the mandatory, and the pro forma budget authority. What you see in the top line of the agriculture bill, which I will use as an illustration, is the 1984 request that we have made compared to 1983 for the purely discretionary programs with which your committee has to grapple. In each case and for each of the 10 subcommittees, we have tried to highlight those programs where the request is nearly the same as what you appropriated in 1983, those programs where there are substantial increases from the 1983 enacted level, and those where there are significant decreases.

In this case the agriculture appropriation request is up by about 9 percent from the 1983 level for these discretionary programs. Obviously, when you get to a line item basis, many of them are level, showing the same level of funding as last year, but significant program increases and decreases also occur.

I thought this would be useful for the staff of the committee and for the members in order to understand that proposing an aggregate freeze

for overall nondefense spending does not mean that we have relinquished the obligation and the right to make priority choices and to increase some and decrease others depending on merit, depending on need, depending on priority. We recognize that you will do the same and that your priorities may differ, but we think the recommendations behind these are solid and we hope you will give them serious consideration.

So this completes the points that I wanted to make, Mr. Chairman. I know that there are many questions on individual programs. There are some on the larger economic and budget issues that we are grappling with and I would be very happy at this point to try to respond to your questions.

Senator STEVENS. Thank you very much. It is a very interesting overview. I think it is very clear what the recommendations are. I believe this committee will thank you for the actions you have taken to meet the congressional priorities that we established for fiscal year 1983. That is a significant gesture I think with regard to that one series of items that you have demonstrated that the administration requested. It is approximately the same as congressional action in fiscal year 1983. It will eliminate a lot of controversy.

DOCUMENT ON ECONOMIC AND FISCAL ISSUES

[The document submitted by Mr. Stockman will be inserted at this point:]

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PART I — BUDGET TOTALS — PRESIDENT'S BUDGET FREEZE AND REFORM PLAN

BUDGET TOTALS AT A GLANCE

	1983	1984	1985	1986	1987	1988
OUTLAYS ...	805	848	919	990	1,058	1,127
RECEIPTS ...	597	660	724	842	916	1,010
DEFICIT	208	189	194	148	142	117

HIGHLIGHTS

- PRESIDENT'S BUDGET FREEZE AND REFORM PLAN RESULTS IN NO REAL GROWTH IN 1984 BUDGET
- REDUCES DEFICIT BY $43 BILLION IN 1984 AND $558 BILLION OVER 1984-88
- MAINTAINS ESSENTIAL DEFENSE BUILD-UP AT $55 BILLION LOWER 5-YEAR COST
- CAUSES DEFICIT SHARE OF GNP TO STEADILY DROP—KEEPING BUDGET ON A PATH CONSISTENT WITH SUSTAINED ECONOMIC RECOVERY

1983	1985	1988
6.5%	5.1%	2.4%

FOUR-POINT BUDGET FREEZE AND REFORM PLAN

1) 1984 Spending Freeze Measures

- No increase in civilian/military pay and retirement.
- 6-month COLA freeze for Social Security and related indexed benefits.
- Freeze on aggregate non-defense discretionary programs, medical provider reimbursement and farm price supports.

2) Long-term Structural Reform

- Bipartisan Social Security Solvency Plan which cuts $79 billion from 1984-88 budget deficit.
- Health care reform and efficiency incentive package involving $58 billion in 5-year savings from Medicare/Medicaid and private health insurance cap.
- Major reforms of civil service retirement, better targeting of means-tested entitlements and veterans benefits.

3) Maintenance of Defense Build-up at Lower Cost

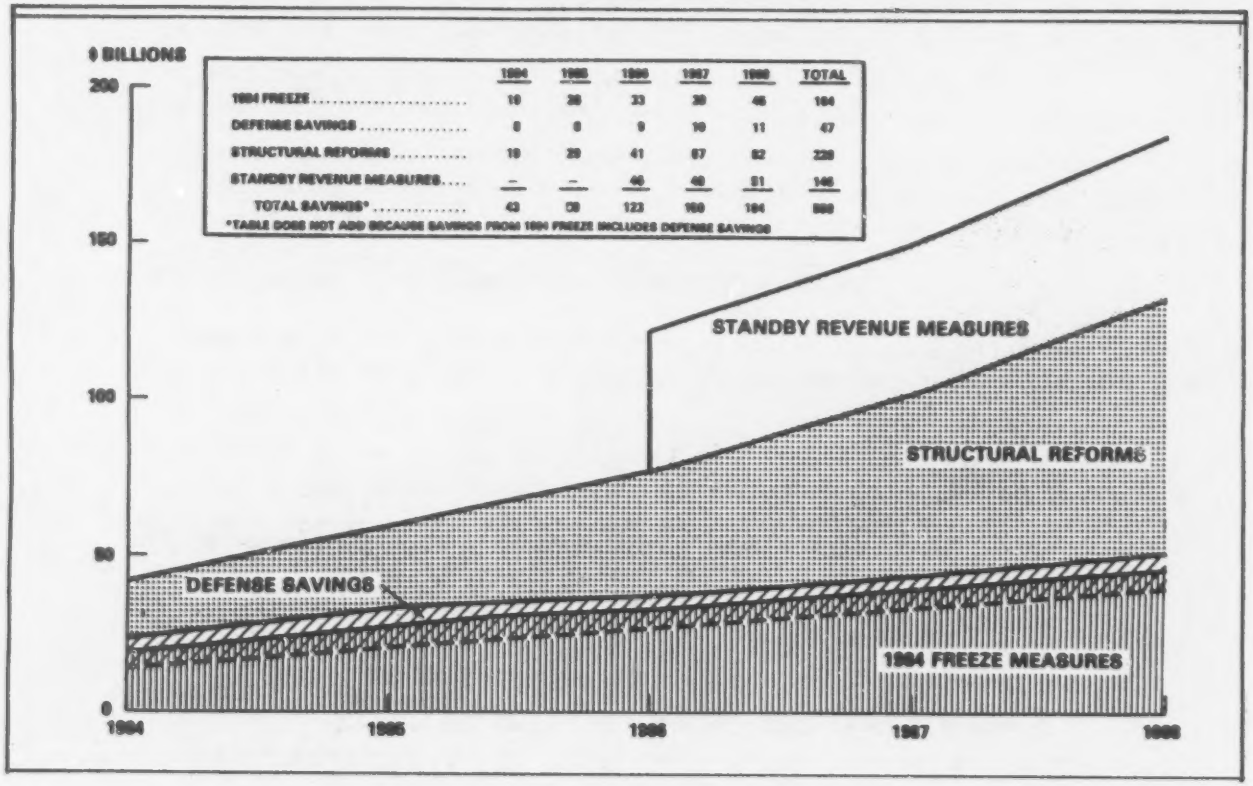
- $55 billion in pay, fuel and inflation and program economies and savings over 5 years.
- Fully protects strategic programs, readiness and sustainability initiatives and conventional forces modernization.

4) Deficit Insurance Policy

- Standby tax equal to 1% of corporate and individual taxable income and $5 per barrel oil excise tax.
- Triggered in FY 1986-88 only if budget freeze and spending reforms adopted, deficit above 2.5% of GNP, and economy in recovery.

(2)

FOUR-POINT BUDGET FREEZE AND REFORM PLAN AT A GLANCE



	1984	1985	1986	1987	1988	TOTAL
1984 FREEZE	10	28	33	39	46	184
DEFENSE SAVINGS	0	0	9	10	11	47
STRUCTURAL REFORMS	10	29	41	67	82	229
STANDBY REVENUE MEASURES	–	–	46	48	51	146
TOTAL SAVINGS*	43	130	123	160	194	650

*TABLE DOES NOT ADD BECAUSE SAVINGS FROM 1984 FREEZE INCLUDES DEFENSE SAVINGS

(3)

AGGREGATE FREEZE ON NON-DEFENSE DISCRETIONARY PROGRAMS

Level Request for Discretionary Programs

- 1984 request for annually funded discretionary programs is $112 billion compared to enacted 1983 appropriations of a similar level. Outlay savings of $4.8 billion compared to 1984 baseline.
- Various trust fund expenditure limits, obligation ceilings and off-budget spending and lending caps save nearly an additional $5 billion in FY 1984 outlays.

Application of Aggregate Freeze Concept

- Targeted high priority programs funded at levels above 1983 appropriation (e.g. law enforcement and anti-drug program, National Science Foundation, Head Start, displaced workers, veterans health care and transportation infrastructure).
- Most programs funded at actual 1983 appropriations (e.g. handicapped education, preventive health block grant, waste treatment grants and WIC).
- Some lower priority programs reduced to below 1983 appropriation to offset targeted increases (e.g. postal subsidies, energy R&D, EDA grants, mass transit, Amtrak and soil conservation).

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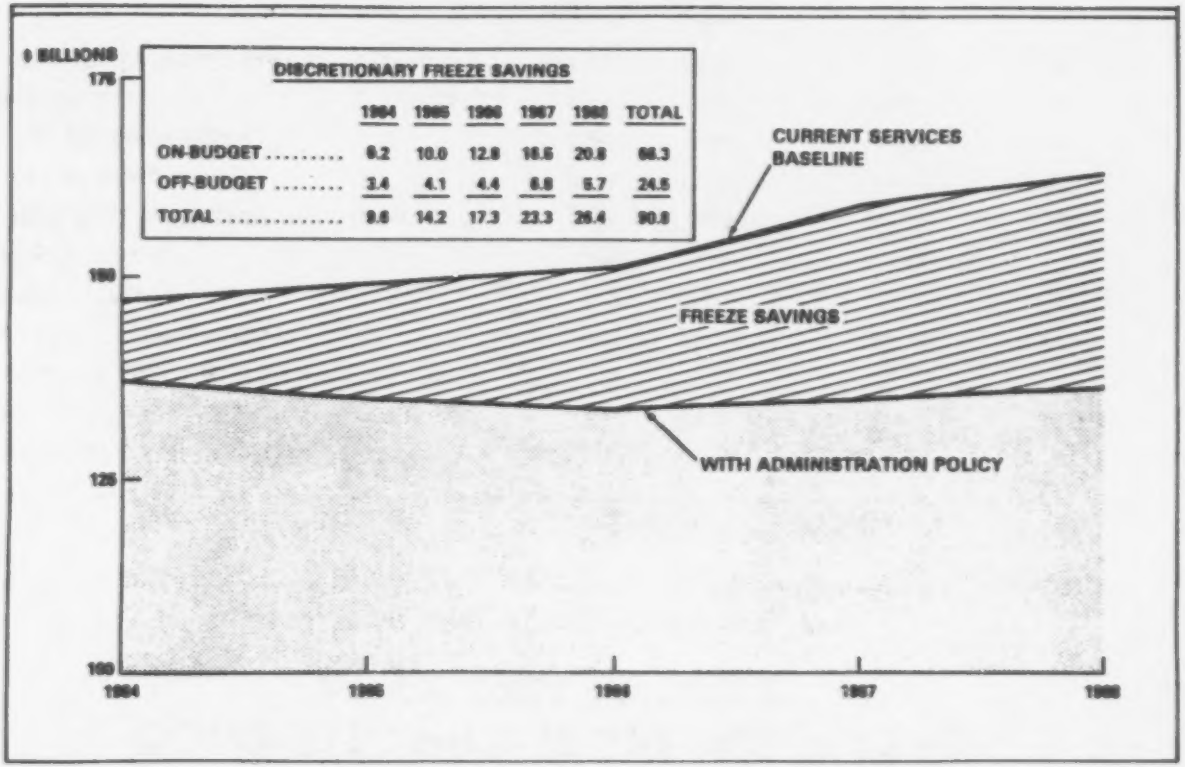
BUDGET IMPACT OF DISCRETIONARY PROGRAM FREEZE



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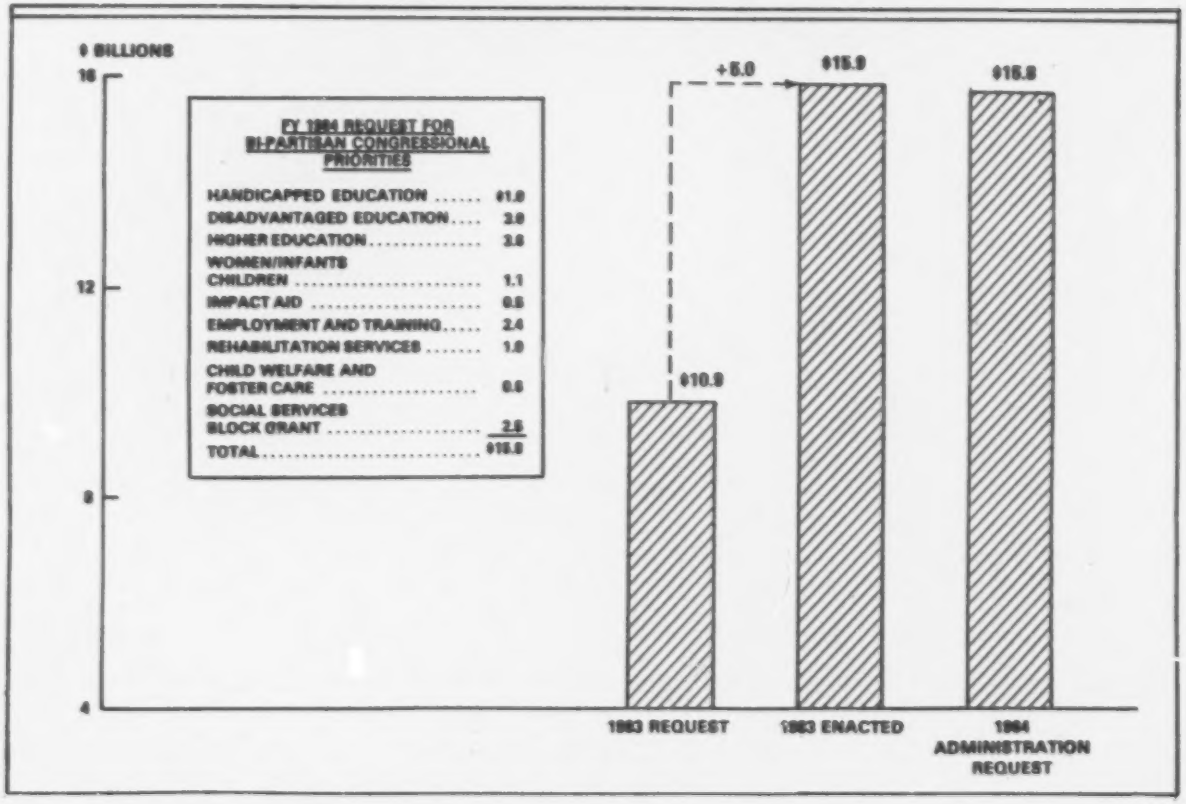
DOMESTIC PROGRAM INCREASES IN FY 1984 BUDGET

(BUDGET AUTHORITY, IN MILLIONS OF DOLLARS)

PROGRAM	1983	1984	INCREASE AMOUNT	INCREASE PERCENT
NATIONAL SCIENCE FOUNDATION	$1,099	$1,297	$+198	+18%
BASIC RESEARCH: ENERGY AND PHYSICS	535	645	+110	+21
SCIENCE AND MATH BLOCK GRANTS	0	50	+50	—
COLLEGE WORK-STUDY	540	850	+310	+57
HEAD START	912	1,051	+139	+15
FOSTER CARE	395	440	+45	+11
DISPLACED WORKERS PROGRAM	50	240	+190	+380
VA MEDICAL CARE	8,292	8,900	+608	+11
LAW ENFORCEMENT	3,045	3,348	+303	+10
HIGHWAYS*	8,100	12,600	+4,500	+56
AIRPORTS AND AIRWAYS	4,180	5,031	+851	+20
TOTAL	$27,148	$34,462	$+7,304	+27%

*OBLIGATION LIMITATION PRIOR TO PASSAGE OF GAS TAX LEGISLATION

1984 BUDGET: RECOGNITION OF KEY CONGRESSIONAL PRIORITIES



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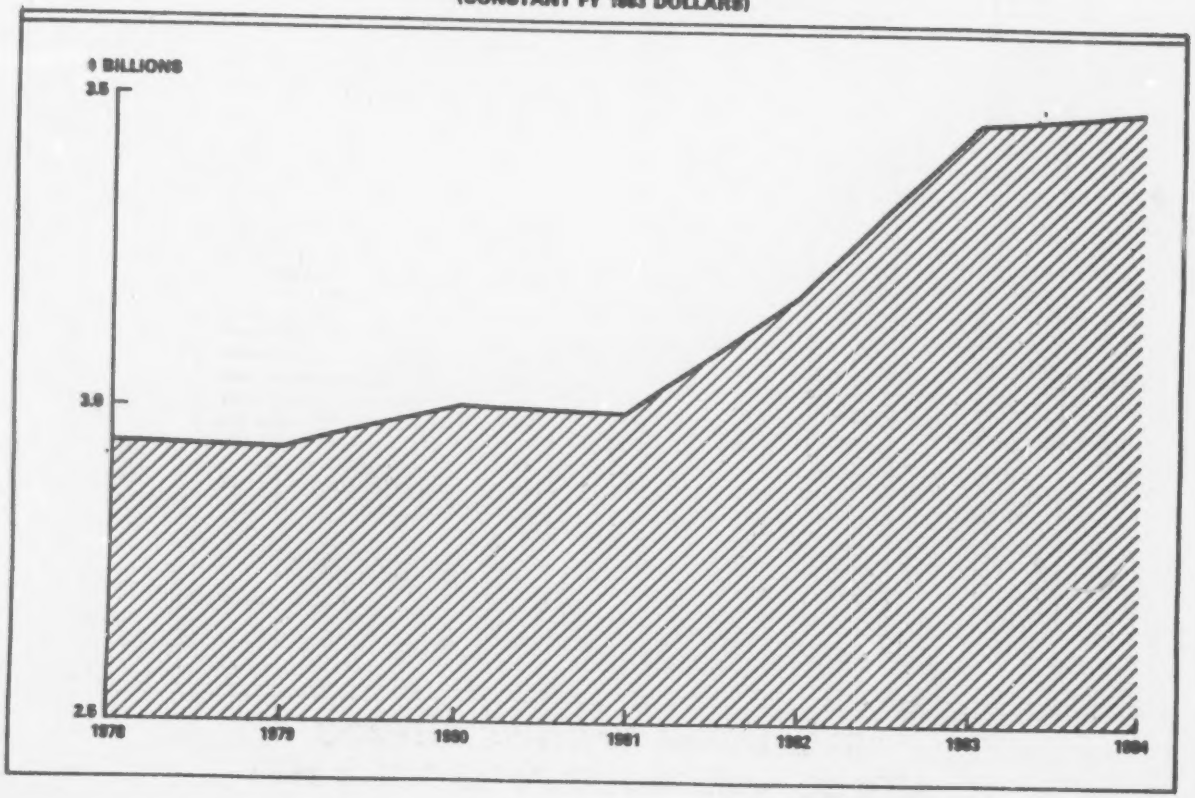
MORE ADEQUATE FUNDING FOR LAW ENFORCEMENT

(CONSTANT FY 1983 DOLLARS)



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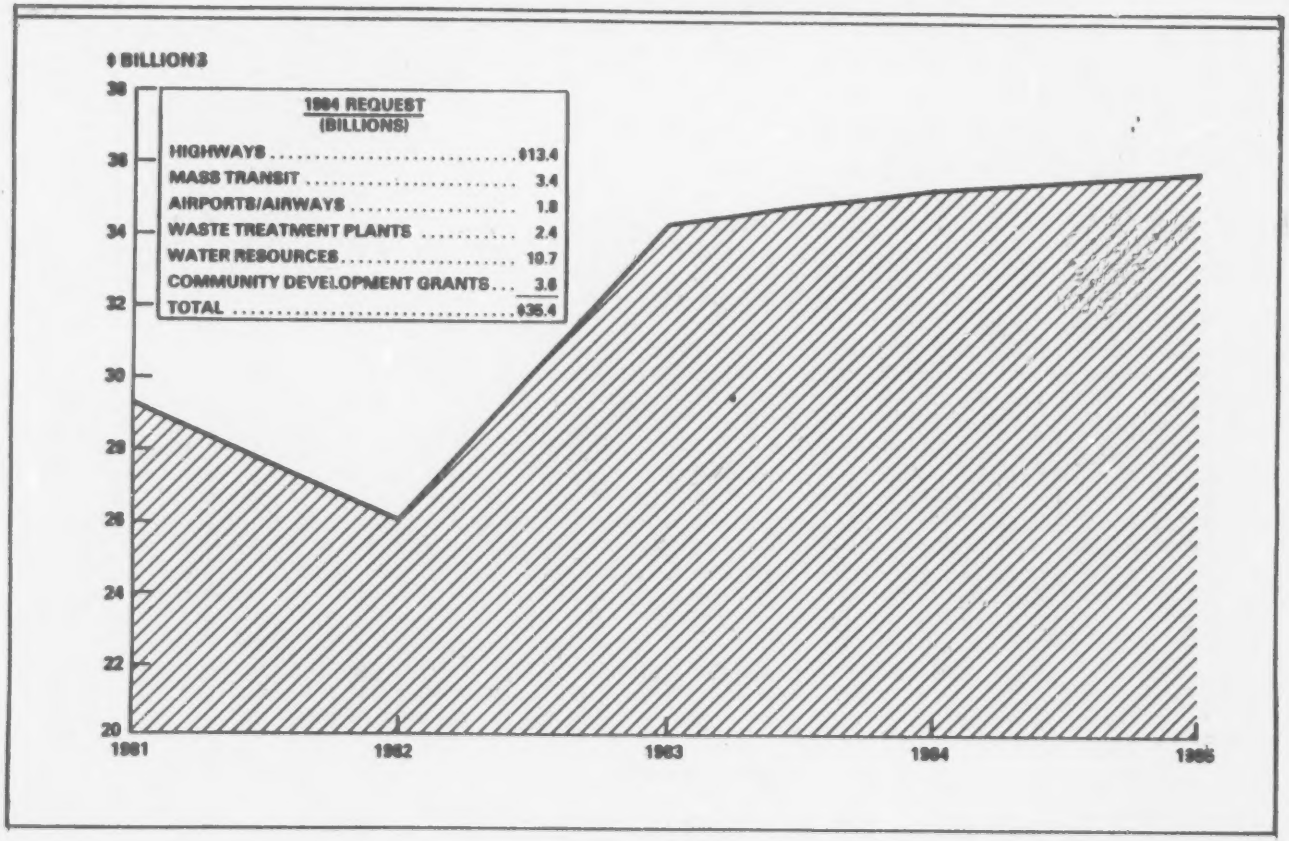
FUNDING FOR PUBLIC INFRASTRUCTURE



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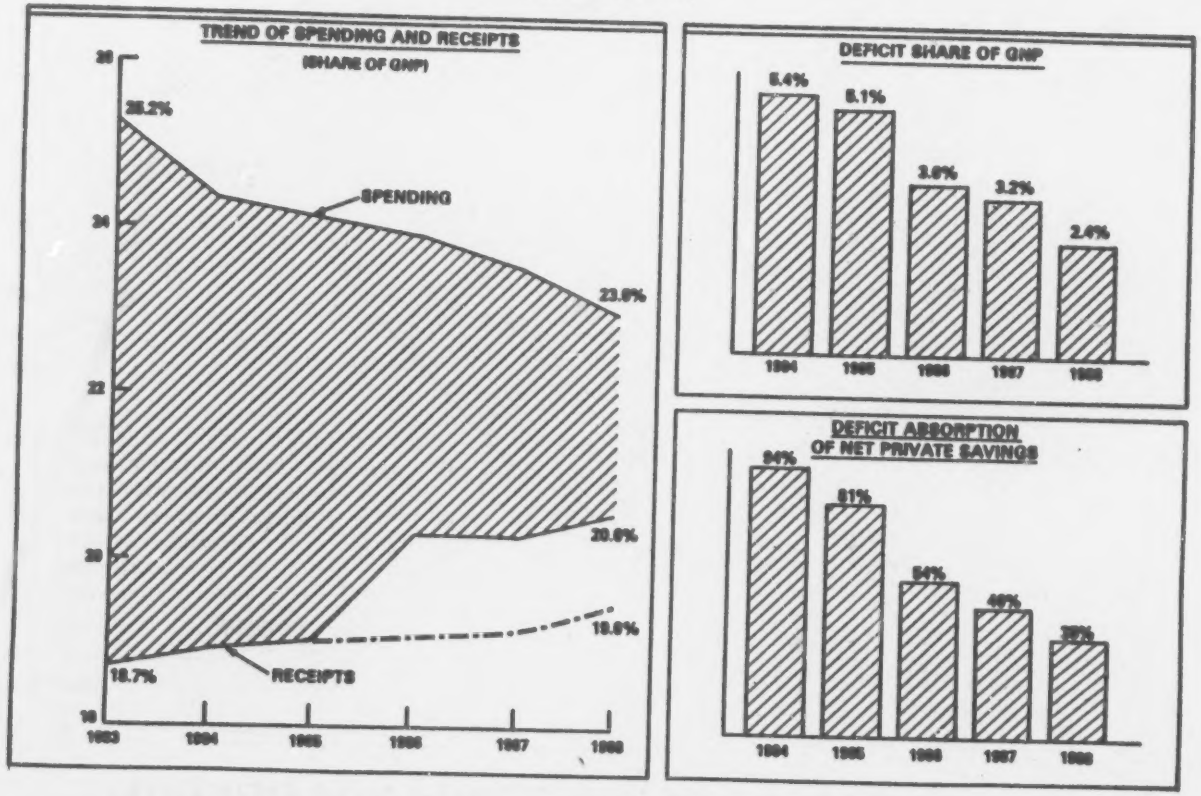
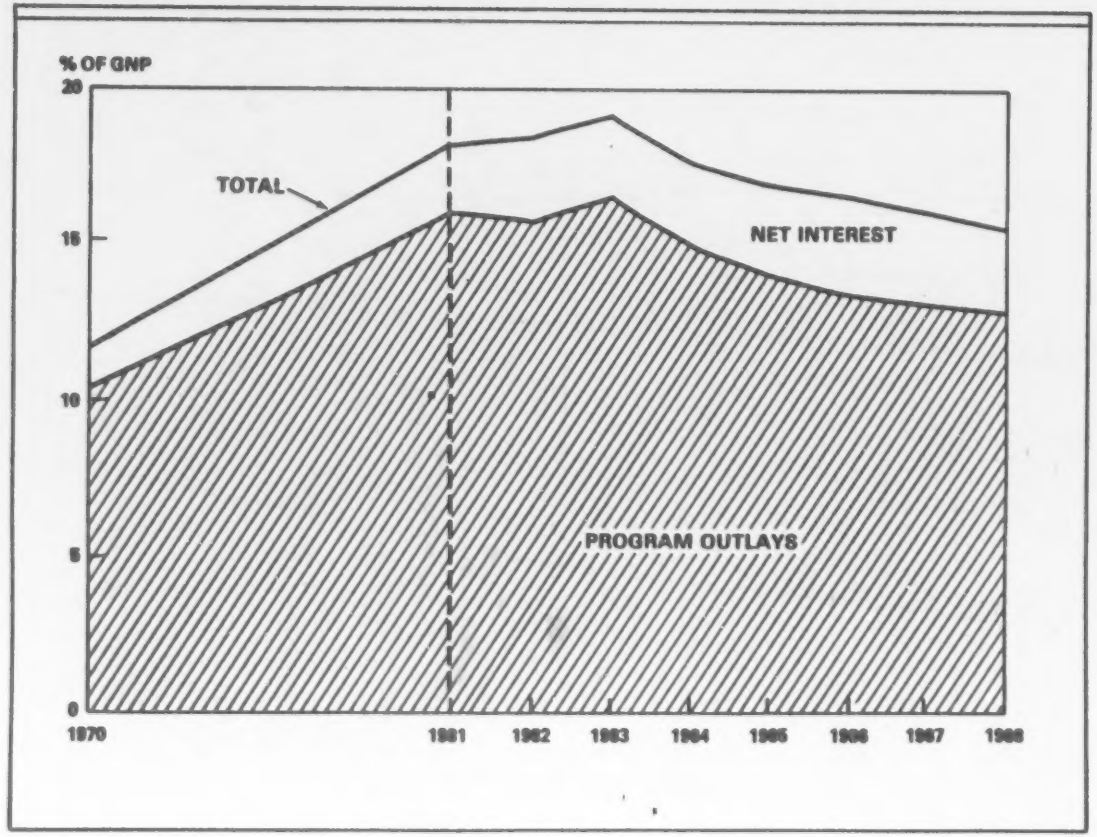
FISCAL ECONOMIC IMPACT AT A GLANCE

(SHARES OF GNP)



NON-DEFENSE SPENDING AS SHARE OF GNP



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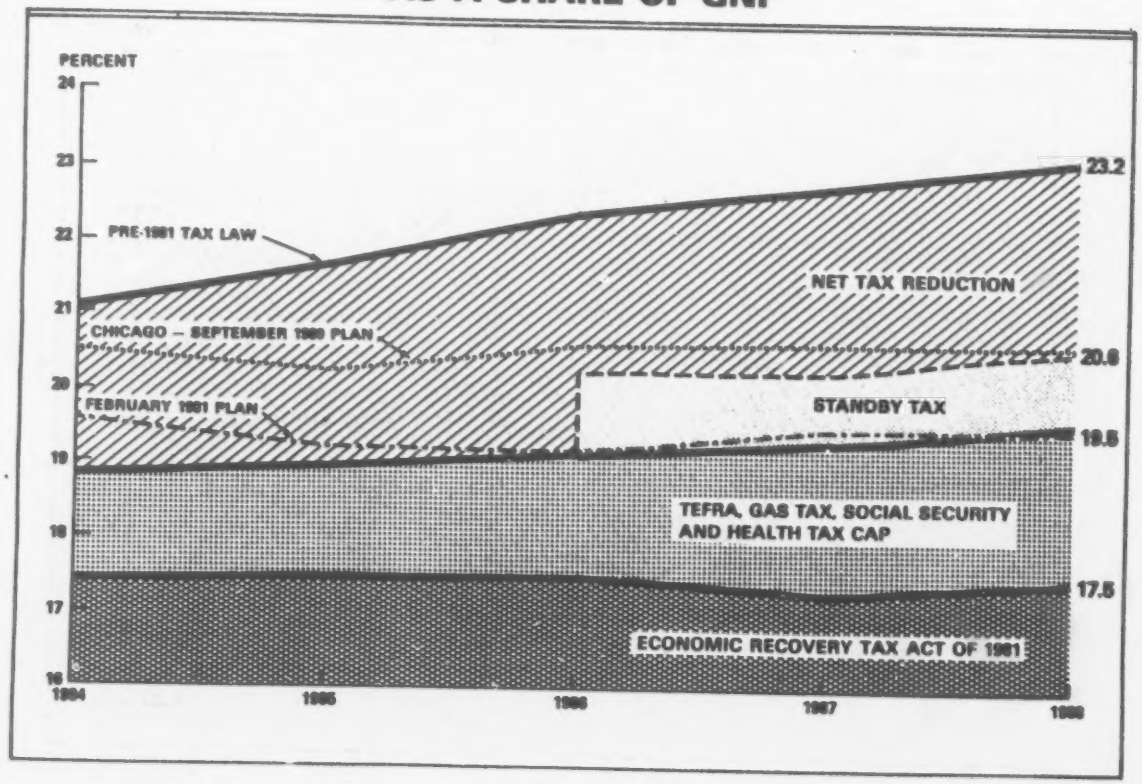
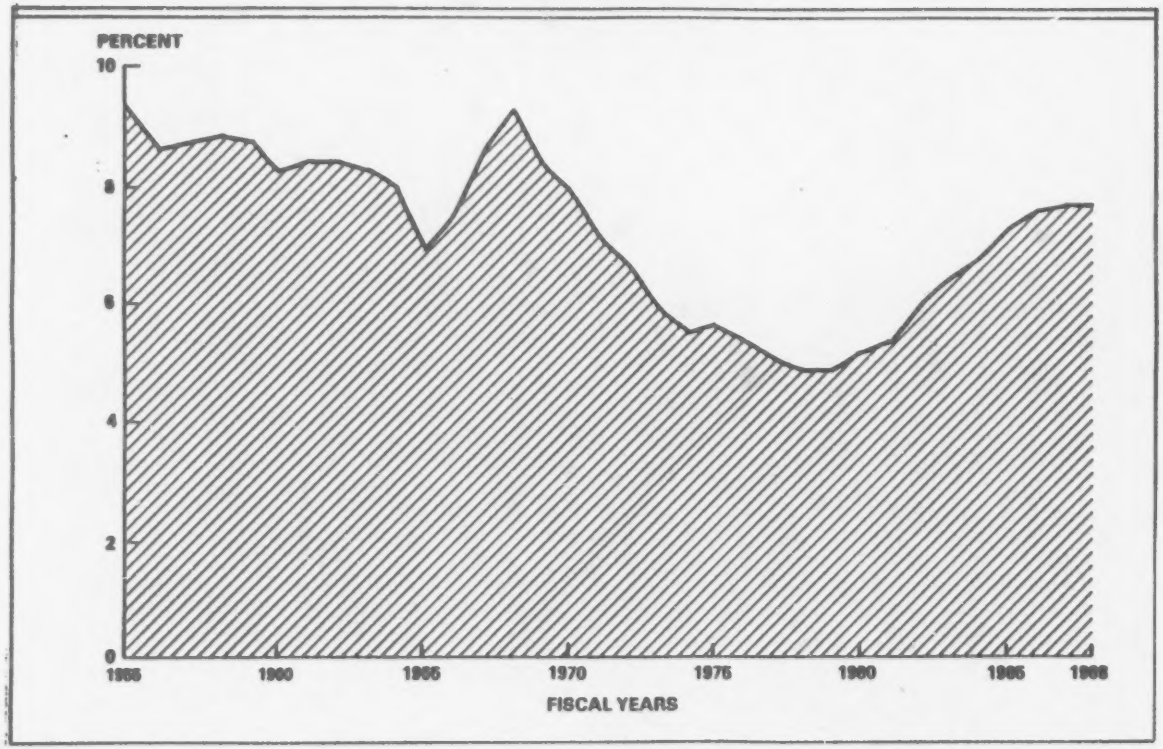
CHANGES IN TAX BURDEN AS A SHARE OF GNP



(12)

DEFENSE OUTLAYS AS A SHARE OF GNP



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PART II - REQUESTS PENDING BEFORE THE COMMITTEE ON APPROPRIATIONS

THE PRESIDENT'S 1984 BUDGET: LEVEL FUNDING FOR ANNUALLY FUNDED DISCRETIONARIES*

- As the President indicated in the State of the Union message, his FY 1984 budget proposes to hold the line on aggregate discretionary funding.
- The jurisdiction of the Appropriations Committee, of course, embraces a far wider scope than simply discretionary programs controlled through appropriations of current year spending authority.
- As the table on the next page indicates, the FY 1984 budget calls for total spending within the aegis of the Committee to rise from $499.3 billion in FY 1983 to a level of $519.3 billion in 1984. This latter total comprises 58% of the President's total spending authority request.
- This increase represents a total budget authority increase of 4.0%, or an increase of roughly 1.3% less than the rate of inflation.
- As I will indicate, however, the source of this increase is in the national security area, and in many of the automatic spending programs that are subject to the jurisdiction of legislative committees. Funding for these items is reflected in the Committee's bills, however.
- By contrast, for annually funded non-defense discretionary programs the 1984 request of $131.5 billion is for all practical purposes level with enacted 1983 funding of slightly over $130.1 billion.
- Overall, the 1984 appropriation's request compares to 1983 enacted levels as follows:

Program Area	Increase (+)/Decrease (-) from 1983 Amount	Percent
Security Agencies	+35.6	+14%
Annually-funded discretionary programs	-1.5(+1.4)*	-1%(+1%)*
Non-defense entitlements, mandatories and non-program BA transactions	-14.1	-10%
Net Increase from FY 1983	+20.0	+4%

* Including trust fund limitations within jurisdiction of appropriations committees.

Table I

FY 1984 BUDGET TOTALS FOR APPROPRIATE PROGRAMS

	1983 Enacted	1984 Request	Difference
	(budget authority in millions)		
TEN DOMESTIC AGENCY BILLS			
Agriculture	$41,532	$35,381	$ -6,151
Commerce/State/Justice	9,759	9,720	-39
District of Columbia	572	576	+4
Energy & Water	15,968	14,463	-1,505
HUD-Independent Agencies	53,292	46,753	-6,539
Interior	7,901	6,733	-1,168
Labor/HHS/Education	95,632	96,313	+681
Legislative Branch	1,456	1,539	+83
Transportation	11,748	11,097	-651
Treasury/Postal	11,479	10,190	-1,289
Overall Total, 10 Domestic Bills	249,339	232,765	-16,574
Discretionary programs excluding entitlements, mandatories and other accounting transactions recorded as budget authority and trust fund obligation limitations*..	130,100	131,500	+1,400
DEFENSE/SECURITY AGENCY BILLS			
Defense	232,027	265,355	+33,328
Foreign Operations	10,811	11,545	+734
Military Construction	7,043	8,655	+1,612
Total, Security Agency Bills	249,951	285,555	+35,604
ALLOWANCE FOR RETIREMENT CONTRIBUTIONS	0	949	+949
GRAND TOTAL	$499,290	$519,269	$ +19,979

* See Table II A-B and III A-B for explanation.

(15)

MAJOR ENTITLEMENTS CHANGES AFFECTING MATTERS WITHIN THE JURISDICTION OF THE COMMITTEE

- As indicated in the State of the Union Address, the Administration is proposing an extensive set of reforms across the full range of so-called entitlement programs.
- These changes include four major initiatives:
  - Endorsement of the recommendations of the National Commission on Social Security Reform, which will ensure the solvency of the system throughout this decade;
  - A major package of health care reforms which will provide the first major restructuring of health care entitlements since the enactment of Medicare and Medicaid;
  - Major reforms of the Civil Service Retirement Systems, which will balance the cost of the program through future benefit restraint and more equitable employee financing;
  - Additional modest reforms of means-tested entitlement programs focused on error reduction and simplification of eligibility and benefit formulas.
- Table IIA shows how these reforms, as well as the Administration's initiatives across the full range of other entitlement and benefit programs, affect the budget request that is now pending before the Committee on Appropriations.
- These law changes and the resulting budget authority changes, of course, are the primary responsibility of the legislative committees. As was the case last year, the Administration believes that the appropriations committees cannot be held accountable for achieving these necessary legislative changes, and that final funding levels for FY 1984 appropriated entitlements should reflect the estimated funding requirements that result from legislative consideration and disposition of these proposed statutory reforms.

TECHNICAL NOTE: Budget authority estimates used throughout this section represent a preliminary decomposition of B.A. according to Appropriations Committee concepts. Final estimates may change after technical reconciliation.

- As Table IIA shows, nearly one quarter of the total request before the Appropriations Committee is comprised of entitlement programs and other mandatory spending.

- Overall, the President's budget request will relieve considerable spending pressure from the Appropriations Committee this year. As the table indicates, appropriated entitlements are expected to rise by only $2.0 billion in 1984 over the 1983 current services level.

- There are two sources of these lower spending levels:

    - Favorable economic developments, notably lower unemployment and interest rates; and,

    - Administration policy proposals, which will further restrain spending in those areas where further restraint is prudent.

- The following table highlights the source of spending changes for major programs in this area:

Program (Program Level in Billions)	1983 Level	Changes Due To: Policy	Changes Due To: Economics	1984 Level
Supplemental Security Income	$ 7.8	$+0.5	$+0.2	$ 8.5
Medicare Part B	15.3	-0.8	+2.9	17.4
Medicaid	19.3	-0.3	+1.7	20.7
AFDC	8.3	-0.7	-0.1	7.5
Guaranteed Student Loans	2.2*	-0.2	(0.9)*	2.0

* Current Services level, net of $900 million 1983 rescission reflecting lower participation and interest rates than originally estimated.

Table IIA

1984 BUDGET TOTALS FOR APPROPRIATED ENTITLEMENTS

Program	1983 Enacted (budget authority in billions)	1984 Request	Difference
Entitlement Programs			
AFDC & Child Support	$8.3	$7.5	$ -0.8
Child Nutrition	3.2	2.9	-0.3
Guaranteed Student Loans	2.2[1/]	2.0	-0.2
Medicaid	14.8[2/]	20.7	+5.9
Medicare Part B	15.3	17.4	+2.1
Advances to UI Trust Fund	10.4	7.2	-3.2
Revenue Sharing	4.6	4.6	---
Food Stamps (includes Puerto Rico)	12.8	11.7	-1.1
Social Services	2.5	2.5	---
Supplemental Security Income	8.5(7.9)[3/]	7.9(8.5)[3/]	-0.6(+0.6)[3/]
Veterans Benefits	15.1	15.4	+0.3
All Other Benefit Programs	5.5	5.7	+0.2
Sub-Total, Domestic Entitlements	103.2	105.5	+2.3
Defense-Related Entitlement & Mandatories	16.5	17.1	+0.6
Other Mandatories	5.7	4.3	-1.4
Permanent & other	0.7	1.2	+0.5
Grand total, entitlements, mandatory program and permanent authorities	$126.1	$128.1	+2.0

1/ Current services level, which reflects rescission of $900 million in B.A. due to lower participation and interest rates.

2/ 1983 BA level assumed only 3 quarters of payments; 1984 reflects 4-quarter funding.

3/ 1983 BA level assumed 13 months of payments; numbers in parentheses reflect actual program level.

ADJUSTMENT FOR BUDGET AUTHORITY TRANSACTIONS THAT HAVE NO EFFECT ON ANNUALLY-FUNDED PROGRAMS

- In addition to entitlement programs, new budget authority requests for certain other programs tend to mask the extent to which discretionary spending is subject to control by annual discretionary funding actions.

- These programs include:

  - Agricultural credit programs, where budget authority is requested for technical accounting reasons, and has no effect in limiting program operating levels which are controlled by means of annual lending ceilings. Appropriations to liquidate CCC lending losses are another example of such budget authority.

  - Subsidized housing budget authority. Appropriations for any one year reflect net transactions involving already-enacted "pipeline" spending authority, and have only an indirect connection to program levels.

- Table II-B shows the extent to which budget authority transactions in these programs effect comparisons of annual program levels.

Discretionary Appropriations Adjusted for Entitlements and Other Non-Annual Appropriations

- Table IIIA shows the effect of netting both of these classes of budget authority out of the 1983-1984 comparison of discretionary programs. As the table indicates, the overall request for discretionary programs, at $111.7 billion, is approximately equal to the $113.2 billion level enacted in 1983.

Table IIB

BUDGET AUTHORITY TRANSACTIONS THAT DO NOT AFFECT ANNUALLY FUNDED DISCRETIONARY PROGRAMS

Program	1983 Enacted	1984 Request	Difference
	(budget authority in billions)		
Major Budget Authority Transactions			
Commodity Credit Corporation[1/]	$16.2	$10.3	$ -5.9
FmHA Credit Funds[2/]	2.3	2.9	+0.6
FCIC Fund[2/]	0.3	0.2	-0.1
Subsidized Housing BA[3/]	5.8	-2.3	-8.1
Uranium Enrichment Budget Authority[4/]	1.8	0.0	-1.8
	$26.4	$11.1	$ -15.3

1/ Pro-forma budget authority to liquidate losses in lending operations.

2/ Pro-forma budget authority to liquidate net transactions with the Federal Financing Bank.

3/ 30-year budget authority for Section 8 program; negative number due to use of excess "pipeline" budget authority for 1984 program and rescission of unneeded balances.

4/ Netted from 1983 appropriation to make comparable to 1984 accounting treatment.

Table IIIA

RELATIONSHIP BETWEEN TOTAL APPROPRIATIONS REQUEST AND REQUEST FOR ANNUALLY-FUNDED DISCRETIONARIES

	1983 Enacted	1984 Request	Difference
	(budget authority in billions)		
DEFENSE/SECURITY AGENCY BILLS:			
Total Request	$250.0	$285.6	$ +35.6
Less Defense-Related Entitlements	(16.5)	(17.1)	(0.6)
ANNUALLY-FUNDED SECURITY SPENDING	233.5	268.5	+35.0
TEN DOMESTIC AGENCY BILLS:			
Total Request	249.3	233.8[1/]	-15.6
Less Entitlements	(103.2)	(105.5)	(2.3)
Less Other Mandatories	(5.7)	(4.3)	(-1.4)
Less Permanents & Other	(0.7)	(1.2)	(0.5)
Less Non-Annual Budget Authority	(26.4)	(11.1)	(-15.3)
ANNUALLY-FUNDED DISCRETIONARIES[2/]	113.2	111.7	-1.5
TOTAL ANNUALLY-FUNDED DISCRETIONARIES	$346.7	$380.2	$+33.5

1/ Includes allowance for employer contributions to retirement; amount is deleted in "Other Mandatories" line.

2/ Totals may not add to detail due to rounding.

Annually Funded Programs Controlled Through Obligation Limitations

- As the table indicates, the President's aggregate appropriations request for discretionary programs amount to 98.7% of the 1983 enacted level.
- The President's budget provides for further increases above 1983 enacted levels for discretionary programs which are considered during the appropriations process, but controlled through annual limitations on trust fund obligations rather than new budget authority.
- Table III-B indicates the effect of factoring these discretionary accounts into the overall freeze equation. As the table indicates, this wider set of discretionary programs is funded, in the aggregate, at a level $1.4 billion above 1983 enacted levels.

Table III B

RELATION TO DISCRETIONARY PROGRAMS NOT FUNDED THROUGH APPROPRIATIONS PROCESS

	1983 Enacted (spending	1984 Request authority in billions)	Difference
Annually-Funded Discretionary Programs	$113.2	$111.7	$-1.5
Trust Fund Outlays Subject to Obligation Limitations:			
Highway Trust Fund	12.6	13.8	+1.2
Mass Transit Capital Fund	0.0	1.3	+1.3
Airport & Airways Trust Fund	.8	1.0	+0.2
Social Security Administrative Expenses	3.5	3.7	+0.2
Sub-total: Non-B.A. Spending Authority	17.0	19.8	+2.8
Overall Discretionary Funding	130.1	131.5	+1.4

AN OVERALL DISCRETIONARY FREEZE

Administration Spending Priorities

- Within this aggregate freeze, the Administration request provides for priority allocations of funds to discretionary programs.

- In certain areas, such as essential law enforcement activities, the Administration is requesting appropriations increases.

- In other areas, such as Postal Subsidies or the Arts and Humanities Endowments, the Administration believes that funding can be lowered without jeopardizing needed services.

- Table IV breaks down, by Appropriations Subcommittee, the way in which the Administration's appropriations priorities for FY 1984 differ from the enacted Committee bills for FY 1983.

Table IV

THE PRESIDENT'S REQUEST FOR ANNUALLY-FUNDED DISCRETIONARIES:
COMPARISON TO 1983 ENACTED BILLS

	1983 Enacted	1984 Request	Difference
	(budget authority in billions)		
TEN DOMESTIC BILLS			
Agriculture	$ 6.3	$ 6.9	$+0.6
Commerce/State/Justice	9.6	9.5	-0.1
District of Columbia	0.6	0.6	----
Energy and Water*	14.1	14.5	+0.4
HUD (Excludes subsidized housing)	27.8	28.9	+1.1
Interior	7.8	6.7	-1.1
Labor/HHS/Education	28.8	27.1	-1.7
Legislative Branch	0.6	0.6	----
Transportation	11.4	10.7	-0.7
Treasury/Postal	6.2	6.2	---
Total, Annually Funded Discretionary Programs	113.2	111.7	-1.5

* 1983 level reflects adjustment for Uranium Enrichment B.A.

Detail may not add to totals due to rounding.

AGRICULTURE AND RELATED APPROPRIATIONS BILL*

1983 Current Services	1984 Request	Difference	Percent Change
6,344	6,895	+551	+8.7%

Essentially Level Funding	1984 Request	Percent Change
o Agricultural research	472	+2.6%
o PL-480	1,052	+2.3%
o WIC	1,093	0%
o Food safety inspection service	334	+1.7%

Significant Increases	1984 Request	Percent Change
o Federal Crop Insurance, Admin. Expenses	279	18%
o Food and Drug Administration	386	+5%
o Department administrative overhead and IG	146	+15%
o Farmers Home Administration, except revolving funds and block grants	475	+4%

Significant Decreases	1984 Request	Percent Change
o ASCS	120	-56%
o Soil Conservation Service	474	-20%
o Animal and plant inspection service	227	-17%
o Extension service	287	-13%
o Cooperative state research	232	-5%

* New budget authority in millions of dollars for annually appropriated programs.

COMMERCE, STATE, JUSTICE APPROPRIATION BILL*

1983 Current Services	1984 Request	Difference	Percent Change
9,559	9,546	-13	-0.1%

Essentially Level Funding	1984 Request	Percent Change
o Commerce & Justice Administration.....	90	0.3%
o Civil Rights Commission & EEOC.....	168	+5.0%
o SBA Salaries & Expenses.....	248	+3.0%
o Census Bureau & ESA...	195	-5.0%
o Patent Office.....	82	+5.0%

Significant Increases	1984 Request	Percent Change
o Federal Prisons.....	535	+29%
o USIA & International Broadcasting.....	827	+28%
o FBI.....	1,056	+24%
o Office of Justice Assistance.....	153	+22%
o DEA.....	276	+8%

Significant Decreases	1984 Request	Percent Change
o Legal Services Corp.....	0	-100%
o EDA Development Assistance.....	0	-100%
o Marad ship construction.....	0	-100%
o SBA Business Loans....	241	-64%
o NOAA.....	797	-11%

* New budget authority in millions of dollars for annually appropriated programs.

ENERGY & WATER APPROPRIATIONS BILL*

1983 Current Services	1984 Request	Difference	Percent Change
14,134	14,466	+322	+2.3%

Essentially Level Funding	1984 Request	Percent Change
o Corps of Engineers (excludes construction).....	$1,682	-1.3%
o Nuclear Regulatory Commission.....	467	+0.2%

Significant Increases	1984 Request	Percent Change
o Nuclear Waste Disposal Bill.....	307	100%
o Energy Science.....	645	+21%
o Bureau of Reclamation.	972	+20%
o Atomic Energy Defense.	6,778	+12%

Significant Decreases	1984 Request	Percent Change
o Appalachian Regional Commission.....	0	-100%
o TVA Fund.....	75	-57%
o Power Marketing Adm...	280	-35%
o Corps Construction....	906	-29%
o Energy Supply R&D.....	2,095	-14%

* New budget authority in millions of dollars for annually appropriated programs.

HUD -- INDEPENDENT AGENCIES APPROPRIATIONS BILL

	1983 Current Services	1984 Request	Difference	Percent Change
Total Bill.....	33,622	26,281	-7,341	-21.8%
Excluding Subsidized Housing.....	27,802	28,872	+1,070	+3.8%

Essentially Level Funding	1984 Request	Percent Change
o EPA Construction Grants.....	2,400	-1.2%
o Urban Homesteading....	12	---
o EPA Salaries & Expenses.....	540	-1.5%
o Community Development Block Grant.....	3,500	+1.3%

Significant Increases	1984 Request	Percent Change
o Veterans Administration Construction.....	674	+66%
o Superfund.....	354	+48%
o NASA Space Support R&D (tracking and data)..	700	+40%
o FEMA.....	522	+24%
o Public Housing Operating Subsidies.....	1,636	+21%
o National Science Foundation.....	1,292	+18%

Significant Decreases	1984 Request	Percent Change
o Solar/Conservation Bank.....	0	-100%
o Subsidized Housing 1/....	514	-94%
o EPA Abatement/Control....	294	-20%
o EPA R&D.....	112	-6%

* New budget authority in millions of dollars for annually appropriated programs.
1/ New appropriation, excluding rent supplement rescission.

INTERIOR APPROPRIATIONS BILL*

1983 Current Services	1984 Request	Difference	Percent Change
7,828	6,661	-1,167	-14.9%

Essentially Level Funding	1984 Request	Percent Change
o Indian Health Service.....	653	-1.1%
o Payments-In-Lieu of Taxes.....	96	---
o Fish & Wildlife Operations.....	249	+2.2%
o National Park Operation.....	600	+4.0%
o Kennedy Center.....	4	+0.1%
o Geological Survey.....	366	-2.9%

Significant Increases	1984 Request	Percent Change
o Pennsylvania Avenue Corp.....	16	+47%
o Abandoned Mine Reclamation.....	219	+36%
o Naval Petroleum Reserve.....	266	+20%
o Smithsonian, excluding construction.....	211	+10%

Significant Decreases	1984 Request	Percent Change
o SPRO Oil (off-budget).	583	-72%
o Energy Conservation, Info., Fossil R&D and Facilities.....	400	-52%
o Park Service Construction.....	78	-51%
o Mineral Management Service.....	156	-22%
o National Foundation on Arts & Humanities.....	249	-14%

* New budget authority in millions of dollars for annually appropriated programs.

LABOR/HHS/EDUCATION APPROPRIATIONS BILL*

1983 Current Services	1984 Request	Difference	Percent Change
28,770	27,083	-1,687	-5.9%

Essentially Level Funding	1984 Request	Percent Change
o ADAMHA	421	+1.5%
o NIH	4,077	+1.9%
o OSHA	211	+2.7%
o MSHA	148	-3.8%
o Impact Aid	465	-3.2%
o Elementary & Secondary Education (excludes impact aid)	3,543	-4.3%
o Title III Higher Education	134	+3.7%

Significant Increases	1984 Request	Percent Change
o PHS Management	123	+30%
o Bureau of Labor Statistics	136	+10%
o Howard University	160	+10%
o Employment & Training Aid	5,441	+5%

Significant Decreases	1984 Request	Percent Change
o Work Incentives (WIN)	0	-100%
o Low Income Energy Assistance	1,300	-34%
o Bilingual Education	95	-32%
o ACTION	110	-15%

* New budget authority in millions of dollars for annually appropriated programs.

TRANSPORTATION APPROPRIATIONS BILL*

1983 Current Services	1984 Request	Difference	Percent Change
11,372	10,691	-681	-6.0%

Essentially Level Funding	1984 Request	Percent Change
o NHTSA	56	+5.9%
o DOT Inspector General	26	+2.2%
o Coast Guard	2,203	+2.7%
o Transportation Research	20	+1.3%
o Washington METRO	52	---

Significant Increases	1984 Request	Percent Change
o FAA Operations	1,603	+27%
o Panama Canal Commission	539	+24%
o (Airport Trust Fund)	(3,379)	(+20%)
o Highway Safety R&D.	9	+12%
o UMTA Capital & Operating	3,915	+10%
o Motor Carrier Safety	13	+10%
o (Highway Trust Fund)	(13,801)	(+9%)

Significant Decreases	1984 Request	Percent Change
o USRA Administration	0	-100%
o Architectural Barriers Board	2	-16%
o Civil Aeronautics Board	21	-12%
o Federal Railway Adm.	889	-12%

* New budget authority in millions of dollars for annually appropriated programs.

TREASURY/POSTAL APPROPRIATIONS BILL*

1983 Current Services	1984 Request	Difference	Percent Change
6,195	6,165	-30	-0.5%

Essentially Level Funding	1984 Request	Percent Change
o Bureau of Government Financial Operations	243	-0.4%
o Customs Service	579	+1.4%
o Bureau of the Mint	50	+4.2%
o Federal Election Commission	10	+3.0
o General Services Administration	602	+4.8
o Merit Systems Protection Board	24	+3.0%

Significant Increases	1984 Request	Percent Change
o Law Enforcement Training Center	$14	+13%
o US Secret Service	271	+13%
o National Security Council	15	+11%
o Internal Revenue Service	3,292	+8%
o Bureau of Alcohol, Tobacco & Firearms	157	+7%

Significant Decreases	1984 Request	Percent Change
o Postal Services Subsidies	400	-49%

* New budget authority in millions of dollars for annually appropriated programs.

PART III - DEFENSE AND SECURITY PROGRAMS

DEPARTMENT OF DEFENSE

	1983 Enacted	1984 Request	Difference
	(dollars in millions)		
DOD Military.....	232.0	265.2	33.2
Military Construction.....	7.0	8.7	1.7
Total.....	239.0	273.9	34.9

PROGRAM HIGHLIGHTS

Strategic Forces

- o $38.5 billion (13.6%) is included for operation and modernization of strategic forces.
  - $6.9 billion for B-1 production (10 aircraft).
  - $6.6 billion for Peacekeeper (MX) development and production (27 missiles).
  - $3.9 billion for production of a TRIDENT submarine, TRIDENT I SLBM's, and development of TRIDENT II.
  - $0.2 billion for acquisition of ALCM cruise missiles.

Conventional Forces

- o $123.7 billion is provided for operation and modernization of conventional forces, including airlift and sealift.
  - $12.8 billion is provided for ship construction, including 17 new ships.
  - $2.7 billion is included for airlift enhancements (C-5, KC-10, CRAF).
  - $9.2 billion is included for tactical aircraft procurement (310 aircraft).
  - $2.7 billion is provided for armored vehicle production (1320 vehicles), including M-1, IFV, light armor.
  - $11.6 billion is provided for conventional munitions.
  - $4.2 billion is included for prepositioning.

Intermediate Range Nuclear Forces

- o $0.8 billion is included for procurement of GLCM (120 missiles).
- o $0.5 billion is included for production of Pershing II (95 missiles).

Guard and Reserve Forces

- o $11.6 billion is provided for guard and reserve force components.

Operations and Maintenance

- o $74.0 billion is provided for operations and maintenance of active forces.

Military Personnel and Retirement

- o $16.8 billion is included for military retirement.
- o $47.9 billion is included for military personnel.

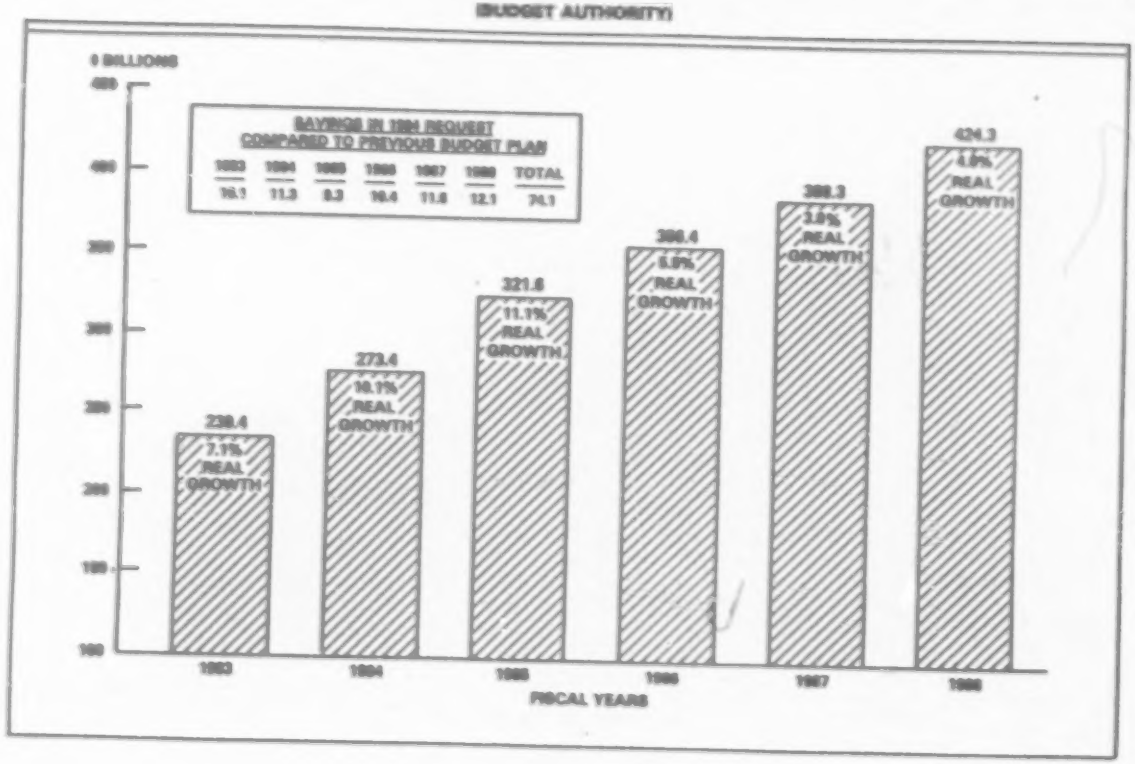
Military Construction and Family Housing

- o $8.8 billion is provided for military construction and family housing.
  - $2.8 billion for operations, maintenance and construction of family housing.
  - $0.4 billion for Peacekeeper missiles.
  - $1.4 billion for NATO/European Theater.
  - $0.3 billion for RDF/Indian Ocean.

190

DEPARTMENT OF DEFENSE BUDGET
1983–1988

(BUDGET AUTHORITY)



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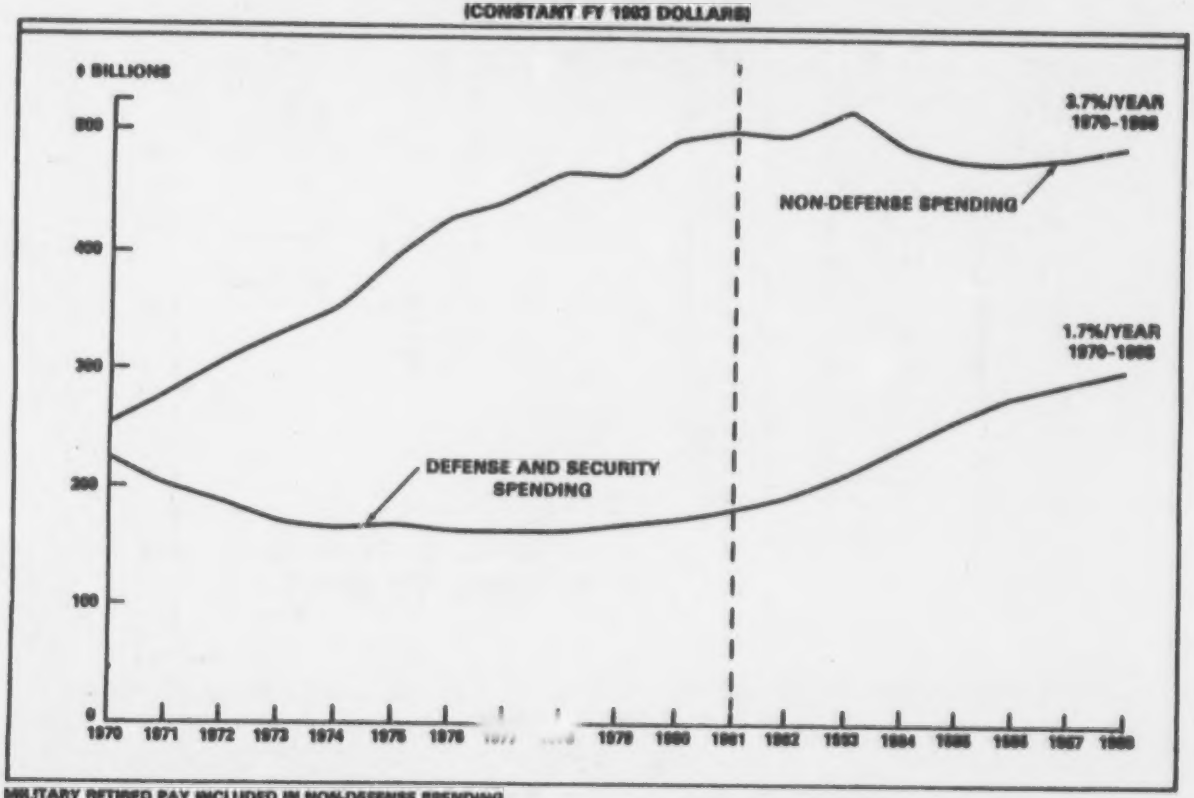
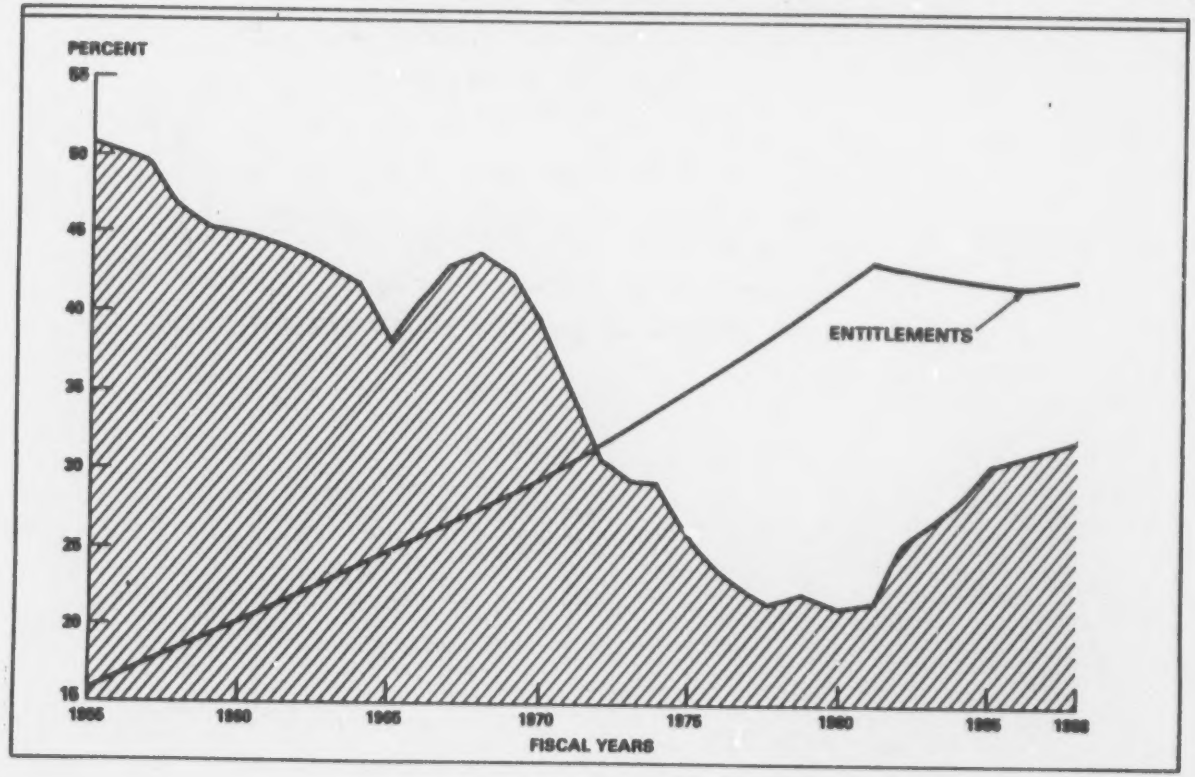
BUDGET PRIORITIES SHIFT IN HISTORICAL PERSPECTIVE

(CONSTANT FY 1983 DOLLARS)



MILITARY RETIRED PAY INCLUDED IN NON-DEFENSE SPENDING
NONDEFENSE SPENDING EXCLUDES NET INTEREST

DEFENSE SHARE OF BUDGET



(37)

	1983 Enacted	1984 Request	Difference
	(dollars in millions)		
Foreign Assistance and Related Programs.....	10.9	11.5	0.6
P.L. 480 Food-Aid (Agriculture Appropriation).....	1.0	1.1	0.1
State and Related Agencies (Commerce, Justice, State Appropriation).....	2.5	3.0	0.5
Total.....	14.4	15.6	1.2

Foreign Assistance and Related Programs Appropriations Request is $11.5 Billion:

- o $1.9 billion for Multilateral Economic Assistance
  - $1.1 billion for International Development Association.
  - $287 million for International Organizations and Programs.
- o $5.4 billion for Bilateral Economic Assistance
  - $1.34 billion for AID.
  - $2.95 billion for Economic Support Fund.
  - $344 million for Refugee Assistance.
- o $1.8 billion for Military Assistance
  - $1.0 billion in Foreign FMS Credits.
  - $0.8 billion in Government Military Assistance.

- o $2.5 billion for Export-Import Bank
  - Allows $3.83 billion in direct loan authority.
  - Loan guarantees request (off-budget) of $10.0 billion.

Foreign Military Scales Credit Obligational Authority (off-budget)request is $4.3 billion

P.L. 480 Program Food Aid request is $1.1 billion (Agriculture Appropriaton)

State and Related Agenices request is $3.0 billion (Commerce, Justice State Appropriaton)

- o $2.1 billion for State Department Operations
- o $0.9 billion for International Information Programs
  - $832 million for United States Information Service.
  - $116 million for Board for International Broadcasting.
- o $21 million for ACDA.

FEDERAL ABSORPTION OF CREDIT

Senator STEVENS. I have just two basic questions. One, take a look at this chart that you have on page 10 which indicates the absorption of net private savings by the deficit. It was my information that on-and-off budget Federal borrowing will take over one-half of all private capital available in this country this year and that if you look at all government borrowing, which includes State and local governments, that figure reaches nearly 60 percent.

Can we really finance a recovery as long as that continues?

Mr. STOCKMAN. Mr. Chairman, I think for a limited period of time we can. Clearly, private demands for credit now are at a very low state. As cash flow improves business demand, credit demand will increase, although not rapidly. However, as we move into the second, third, and fourth year of the recovery when we must have a major boost in long-term capital spending, it seems to me that with that kind of absorption of private savings we will run into the real trouble.

That is why I think the 3- or 4- or 5-year perspective on the budget now is critical. There is very little we can do about 1983. That is baked in the cake. It is nearly so for 1984. That will not harm the near-term recovery, which is stemming from the natural forces that rebound in the economy. But if we are to sustain it, we need a sustained boom over the long run in capital spending. Unless we get the Federal Government and other levels of government out of the credit market to the extent that they are in it today, we can't have both.

I think the challenge for 1985, 1986, and 1987 is to put in place a budget plan that substantially reduces that fraction or share of private savings or credit market funds that we are absorbing.

FISCAL YEAR 1984 INFLATION RATE

Senator STEVENS. Have you made a projection or estimate of what the inflation rate is going to be over 1984 in this presentation? What is your estimate for inflation?

Mr. STOCKMAN. It is about 5 percent. In the outyears we see it coming down slowly but not dramatically. It stays in the 4- to 5-percent range. That is obviously just an estimate, but it does represent something that is very important with respect to policy. We have made enormous gains at terrific costs in removing and pushing this inflationary spiral from the economy, and we must do everything possible as we move into recovery to insure that those gains are preserved. Even as the economy and employment and real activity pick up, we must hold the inflation rate where it is today and continue to make progress if at all possible.

FREEZE ON CIVILIAN AND MILITARY PAY

Senator STEVENS. You made recommendations here for a freeze on both civilian and military cost-of-living adjustments for salaries in 1984. Is that right?

Mr. STOCKMAN. That is correct.

Senator STEVENS. Is that triggered by any particular level of inflation? If inflation exceeds 5 percent, will there still be a freeze?

Mr. STOCKMAN. As we have proposed it, it would be a 1-year pay freeze. If there is some risk that inflation would move back into the 7- or 8- or 9-percent range, I think it is something we would reevaluate. We think the odds of that are almost negligible at the present time when you consider the inflation of the last 3 or 4 months and the fact that wholesale prices declined in the first month of this year—the largest rate in recorded history.

I understand your concern about the upside risk. We really won't make that decision until this summer when the pay proposal is before the Congress. If there should be some reason to reevaluate it, at that time we could. Right now, at this low level of inflation, I think it is fully justified to have a pay freeze.

EFFECT OF OIL PRICES ON THE BUDGET

Senator STEVENS. Let me add one last question. Then I want to yield to my friend, Senator Stennis. The OPEC countries are going through a price reduction as far as crude oil is concerned. It looks like it is going to be worldwide, a sliding scale for awhile.

Will the fact alone that we are now facing maybe $5 to $7 a barrel reduction within the near term or within the next month, change these figures at all?

Mr. STOCKMAN. The budget figures or the inflation projection as a whole?

Senator STEVENS. The budget figures. How much does the full cost of oil impact this budget?

Mr. STOCKMAN. Mr. Chairman, I will supply specific numbers for the record.

Senator STEVENS. I would like to see that.

Thank you, very much.

[The information follows:]

BUDGET IMPACTS OF LOWER OIL PRICES

On a static basis, the direct budget impacts of lower world oil prices in fiscal years 1983 and 1984 have been evaluated for two oil price paths—$25 per barrel real fiscal year 1983 dollars (FAS) and $30 per barrel real fiscal year 1983 dollars (FAS).[1]

The $25 path is estimated to result in an increase in the deficit of $2.1 billion in fiscal year 1983 and $6.9 billion in fiscal year 1984 over the President's fiscal year 1984 budget. The $30 path is estimated to result in an increase in the deficit of $0.8 billion in fiscal year 1983 and $2.3 billion in fiscal year 1984.

These estimates do not take into account the indirect effects on the budget of lower world oil prices. We recognize that the economic feedback could alter the budget estimates in a more substantial fashion. The administration is conducting a study of such effects over the next few weeks. At that time we should be in a better position to estimate such effects.

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[1] FAS refers to the freight along side cost. The $25 per barrel case represents the real price (in fiscal year 1983 dollars) to which oil prices fall in fiscal year 1984. In nominal terms this is equivalent to a $28 IRAC (import refinery acquisition cost) in fiscal year 1984 on which budget estimates are prepared.

SOCIAL SECURITY ESTIMATES

Senator STEVENS. Again our congratulations to you.

Mr. STOCKMAN. Thank you.

Senator STEVENS. Senator Stennis?

Senator STENNIS. Mr. Stockman, I certainly don't want to detract anything from the fine work you have done even though you, like others, miss the estimates and all and cannot fully explain the reason. That is part of this budget problem.

It seems like headway has been made and we are getting together on something in this massive social security problem for future years. You couldn't have a better illustration of the almost impossible delay. There have been certain figures that have come out in the last few days.

Someone said the estimates are too low and predicted that a much larger figure was needed to put the system in balance. But I understand those predictions are based upon years beyond the year 2000; is that correct?

Mr. STOCKMAN. Senator, as a matter of fact, those are the 75-year so-called long-term estimates. We have to be concerned about that. However, given the fact that I cannot find an economist who can predict for 75 days, I don't know how we can put a great degree of accuracy on 75 years.

The newest estimates are only marginally different on a 75-year basis than the ones we had last year.

Senator STENNIS. So we can rest assured, then, that this additional amount that is being talked about is for the years beyond your estimate anyway; is that correct?

Mr. STOCKMAN. They are basically for years beyond 2015, which is where the real problem begins to emerge. The commission package addresses at least a modest definition of the gap. It seems to me that if we can implement all of that now, we will have left a major legacy of improvement for the future.

Senator STENNIS. Is there any way to avoid this uncertainty beyond the year 2015? People ought to be told if there is no way to do it, I think.

Mr. STOCKMAN. I don't think you can either. The major reason for the change from last year from 1.8 to 2.0 is that the actuaries and the people at the Census Bureau decided the fertility rate was going to decline from 2.1 to 2.0. That causes the whole change. I don't know how that is going to happen.

REFORMS IN HEALTH CARE

Senator STENNIS. Anyway, you have answered the question for your part as I understand it. I think you contribute something here to the solidarity of the package, original package, that we are now considering.

You use the term as I understood you, something with medical reform.

Mr. STOCKMAN. That is correct.

Senator STENNIS. I am glad to hear you use that term because I don't think there is any doubt about the overwhelming need and it is correct

that there has to be some effective medical reform in some areas. But what reform were you talking about to illustrate it now?

What reform were you talking about as being necessary to assist your purpose?

Mr. STOCKMAN. There are three areas.

First is in medicare. We have proposed a number of changes, but I will explain two major ones. First, an increase in the part B premium phased in over 5 years. If you remember back in the sixties, when medicare was put in, the idea was that the physician's part of the program would be funded 50 percent by beneficiaries, and 50 percent by the Federal Government. We have allowed that to erode all the way down to 25 percent. What we are proposing is to raise that back up to 35 percent over 5 years. So the beneficiary's premium would be 35 percent of the cost, and the Federal Government would pay 65, but phased in over 5 years.

The second change is to implement a catastrophic protection for the hospitalization coverage under medicare so that people in a hospital for more than 60 days in 1 year would have no out-of-pocket cost. In 1984, if you are in for 150 days you have a $13,500 hospital bill. This can bankrupt over 100,000 people every year.

We are proposing to eliminate out-of-pocket cost sharing after 60 days, but in return ask people who are relatively less sick—in for short stays, 5 days, 10 days, 15, and so forth—to pay an 8-percent copayment for the 2d to the 15th days and a 5-percent copayment for the remainder of the days through day 60.

What this does is shift this heavy cost burden from a very few, very sick, catastrophically ill people to the large number of people who use medicare out on a routine basis. It would save money because it will reduce utilization of the hospital system by shortening stays and reducing excess hospitalization through medicare.

That is the first big part of it.

The second one is to put a cap on the tax excludable amount by which employers can provide health benefits to employees. Today the entire cost of the health benefit package is excludable from the income tax. As a result, you have some packages today costing $3,000 per family because of the tax subsidy. We are proposing to cap that at $175 a month for a family plan, in order to encourage less first dollar coverage and more cost-consiousness on the part of the private health care users.

The third set of changes is in medicaid. These primarily involve extending beyond 1984 the incentives for State cost control that Congress put in the Reconciliation Act of 1981. In addition, it would make mandatory copayments such as $1 per visit, under medicaid in order to discourage the enormous overutilization of facilities that we have today.

So those are the basic features of the package. Altogether, these add up to $58 billion in deficit reduction over the next 5 years.

Senator STENNIS. You certainly touched on some of the most vital parts of this problem in fields where something cannot be done perhaps, where it will be done. Of course that is another question.

I am glad to see you got that directly on the record. I don't have any doubt about it unless a better system is worked out in this very field. This is going to be of course a continued trouble.

I extend that statement, Mr. Chairman, to the whole concept of management too, to the management of these programs. We have got to improve. That is where the great deal of the cost is being run up. I say that based partly on personal observation, just doing it as we go along. I see things in my own experiences.

So that is true with many of our Federal programs. There has got to be better administration of it.

MANAGEMENT OF HEALTH CARE PROGRAMS

Mr. STOCKMAN. Senator Stennis, I might say that is part of the package. One of our problems is the reimbursement system. If you pay people on a cost plus basis, you are going to have a lot of excess cost, a lot of excess utilization, and a lot of unnecessary treatment.

What we are proposing to do in the medicare area is reimburse hospitals on a fixed payment basis, so that if they spend more than the fixed payment for a particular diagnosis or case, they have to eat it. If they spend less, they can keep it.

Senator STENNIS. On a what?

Mr. STOCKMAN. A fixed price basis. So in every case of an appendectomy, for instance, you pay *x* amount. That would provide a strong incentive for the hospital to hold down costs and to reduce the stay to that needed for medical purposes. We believe that over time this will have enormous positive effects in bringing efficiencies into the whole medical delivery system.

Senator STENNIS. You are doing that as much to protect the hospital as you are anyone else; is that right?

Mr. STOCKMAN. That is correct.

DEFINITION OF JOBS CREATION

Senator STENNIS. I think it is a very constructive observation. My time would be up. When you talk about jobs now, I noticed the administration to a small degree is advocating something on jobs.

What do you mean when you say jobs? What do you think of them? I think of certain things. I go back to the old days of the CCC camp. I remember it, you see. You don't go back that far.

What are you thinking about when you say jobs?

Mr. STOCKMAN. Mr. Chairman, you are right. I don't go back that far, but I did read about it. What I think we are talking about is two things. One, most of the jobs we need have to be generated by the private sector. I think you agree with that and so do all members of this committee.

Sometimes we get so focused on bills that produce 100,000 or 300,000 jobs that we forget that just 4 or 5 percent growth in the economy each year will generate 2 million to 3 million jobs in the private sector—permanent jobs, generating real wealth and real opportunities. That is where our primary focus has to be: Taking policy action that will further the recovery, sustain it, and, I hope, make it stronger.

As an interim step, we have agreed with those in Congress to see that some Federal construction, repair, and renovation activity that is already in the budget or already funded in a trust fund program can be accelerated to give a boost to the early stages or early months of the recovery. So we have been talking with Members of the House and Senate about that rather limited and nontraditional approach to jobs at this stage of the economy.

In other words, we are not putting money on a stump to be spent for any kind of make-work job that somebody can concoct, but we are going to the Forest Service or the Veterans Administration and saying, what is your construction schedule, can we move it forward? We believe that that will be a constructive and positive thing to do.

We would urge this committee, as you take up the jobs issue and the emergency supplemental in a matter of weeks, that whatever you do in the jobs area be guided by the principle of taking money that is already in the budget or funds that must be spent for basic national purposes and accelerate them in time, instead of creating new programs or setting money on a stump for somebody to dream up how to spend it. We cannot afford to do that. It will set back our longer-term recovery in jobs goals.

Senator STENNIS. My time is up.

I thank you, very much.

Senator STEVENS. Thank you, very much, Senator Stennis.

Members of the committee, I am going to turn on the front machine.

David, you know what that means.

We have 5 minutes per member. We would ask you to keep your replies succinct.

Gentlemen, we have two other witnesses who must testify and that is the reason I must do this.

Senator Rudman?

ECONOMIC EFFECTS OF OIL PRICE DROP

Senator RUDMAN. Thank you, Mr. Chairman.

Mr. Stockman, that was an excellent presentation. The prepared statement and the charts are going to be very helpful. I just want to inquire about a couple of things.

I find your exchange with the chairman about energy costs rather interesting. It is almost the situation where what you are really saying is, if they win, we loose, and if they loose, we loose. Of course, you are using that to offset income from windfall profits against costs, but isn't that kind of an oversimplification?

Mr. STOCKMAN. Yes.

Senator RUDMAN. If, in fact, we had a 10-percent decrease in energy costs, in terms of the generative effect in the economy, there would be some other measurements.

Mr. STOCKMAN. I would agree with that. I was talking about the direct impact on the budget when you are buying oil or taxing it. But then you have the second order effects of a stronger economy, which means lower unemployment outlays, and lower inflation, which means lower cost-of-living adjustments.

No one really can predict very accurately what the economic impact would be, but the impact obviously would be favorable.

EFFECT ON RECEIPTS OF LARGER GROWTH FIGURES

Senator RUDMAN. This brings me to my major question; looking at the chart on page 10, I understand from reading information that has come out of your office that your economic assumptions, in terms of growth, tend to be very, very conservative in relation to some of the private comments we will get and that is fine.

I think it is probably better to do it that way this year than do it the other way. I can understand that.

But I would like to ask you, looking at this chart, looking at the lower number, the receipts number, what is the effect if in fact the growth rate in the economy over the next 12 months is, let's say, an additional 1 percent above what you forecast.

Mr. STOCKMAN. The impact on it for a growth rate of 4 percent rather than 3 percent would be $10.3 billion. If it were 5 percent, it would be $21 to $22 billion. That is a permanent change in the level of the deficit. That means you save additional money in the outyears because you have less debt service.

STATUTORY CHANGES IN ENTITLEMENTS

Senator RUDMAN. I have listened with interest to your commentary about what this committee can and cannot do. There certainly is a great feeling of frustration in those instances when the committees do not make the kind of statutory changes that are necessary. Let us take a hypothetical.

Four or five months from today those essential statutory changes in a number of the entitlement programs are, in fact not made. We come to the committee without having accomplished those important reforms. What could you propose to us then, Mr. Stockman, in terms of future tax programs?

Mr. STOCKMAN. That is the kind of speculation that we would find a little premature. We assume Congress will look hard at these measures and not do everything precisely the same way that you propose. Nevertheless, you have to address the heart of the budget consisting of COLA's and entitlements. For this committee, if those steps are not changed, then you would have to appropriate more money.

There is no way around it. You could avoid doing that when we need a supplemental in the spring of 1984. We all know that game. It is not worth playing.

I think that on the basis of our cooperative experiences last year, we can continue on that basis this year.

INCREASING TAX BURDEN

Senator RUDMAN. I would respond to that—I agree with what you say—simply by making this general observation.

I agree that we ought to fight the good fight for the next 3 to 5 months, try to make these changes. I think they are essential. I have felt

that way for a long time. I came here feeling that way. But we are after all the elected representatives of the people. The people are being represented in such a way that we do not make those reforms, then I think we are going to have to pay for them. If the American people say they do not like big government, but they like what big government does for them, that is fine. But let us pay for it.

There is not a private economist that I have talked to who says over the next 6 to 8 months if there is any slight hint that the trendlines of these deficits start to lean the other way, we will loose it all.

The Prime Rate will move up. I do not think we can afford to take that risk. I understand if you do not want to answer such a hypothetical question, but I hope the administration has a plan.

If in fact the elected representatives of the people are not willing to make these basic changes so long overdue, then it seems to me the American people will have to be told they will have to pay for them.

Mr. STOCKMAN. If I could respond to that—I guess I did not see the full dimension of your question. I agree in principle. Over the long run you must pay for the government that you want through taxation.

Anybody who believes you can bond finance the Government to the tune of triple digit numbers for a sustained period of time simply does not understand elementary financing and economics.

But I would point out that if these changes are not made, we are talking about a tax burden that is far higher than anything we have had historically. We are talking about a level of burden on the economy that will be extremely counterproductive.

The argument I have gotten all the way through these hearings is that we have depleted the revenue base and there has been an enormous leverage of revenues and the whole problem of the deficit is that taxes were cut too much.

But if you look at this plan before you—the chart that you referred to on page 10—you will see that with the standby measure, which we believe is going to be needed, you will be taxing the economy to the tune of 20.5 percent of GNP in the outyears. That is as high as it was in 1981 before enactment of the tax measures we proposed, and far higher than it was during the seventies, when it was about 19 percent of GNP. It is also higher than it was in the sixties, when we had the last period of sustained strong economic growth.

Therefore, those who argue that we should not make changes in medicare and medicaid and we should not cap COLA's are either arguing for triple-digit bond financing forever or for a tax burden at 22, 23, or 24 percent of GNP, higher than anything you have experienced in history. Neither of those would be very encouraging, in my view, for the future economic prospects of the country.

Senator RUDMAN. I think that is a very important point to make. I wanted to call to Mr. Stockman's attention that that list of bipartisan compromises did not extend to page 26. I see in spite of the congressional action of the last 2 years, you were still recommending the abolition of the Legal Services Corporation in this year's budget.

Mr. STOCKMAN. We tried to accommodate.
Some principles remain.

ECONOMIC ASSUMPTIONS UNDERLYING BUDGET

Senator STEVENS. Senator Proxmire?

Senator PROXMIRE. Mr. Stockman, I do not think we have ever had anybody in your job in the 25 years I have been a Member of the Senate who was better at figures and more in command of all the facts relating to the Office of Management and Budget and its predecessor than you have been.

It is a pleasure to have somebody as competent as you are testifying before us. I think you do a fine job. At the same time, I would like to refer to the first chart you have presented to the committee, the chart entitled Budget Totals at a Glance. This chart shows deficits falling from $208 billion this year to $117 billion in 1988. Of course $117 billion a few years ago would have been considered a horrendous budget deficit at any time under almost any circumstances. Yet this projected deficit is based on the following very optimistic assumptions. First, Congress will keep outlays at or near the level requested by the administration. The Congress may change them, but the net will be about the same. Second, the standby tax increase that you proposed for 1986 to go into effect in 1986 will be adopted by the Congress. Third, although you are very modest in your economic growth estimates for 1983, probably more modest than the average private economist, economic growth will continue over 6 years. The only time we have had that long a period of growth in recent years was in the sixties, when the Vietnam war undoubtedly kept it going. You also assume there will be a steady low level of inflation and a moderate interest rate level.

It seems to me those are all very happy and optimistic assumptions that are quite improbable on the basis of our historical experience, so we are likely to end up with deficits that are considerably higher than you project here.

Do you argue with that?

Mr. STOCKMAN. I think I would, although I recognize that when you forecast out 4 or 5 years you are in the realm of the uncertain, the imponderable, with a wide range of error. We have seen that in the last 2 years not only in terms of what we projected, but in what CBO and the budget committees projected.

Nevertheless, I would still disagree for this reason: The 4-percent real growth over 5 years that you see in this chart equals the 24-quarter average for all recoveries in the postwar period. I do not have it in this table but I will send you another chart that displays each of the recoveries.

[The chart follows:]

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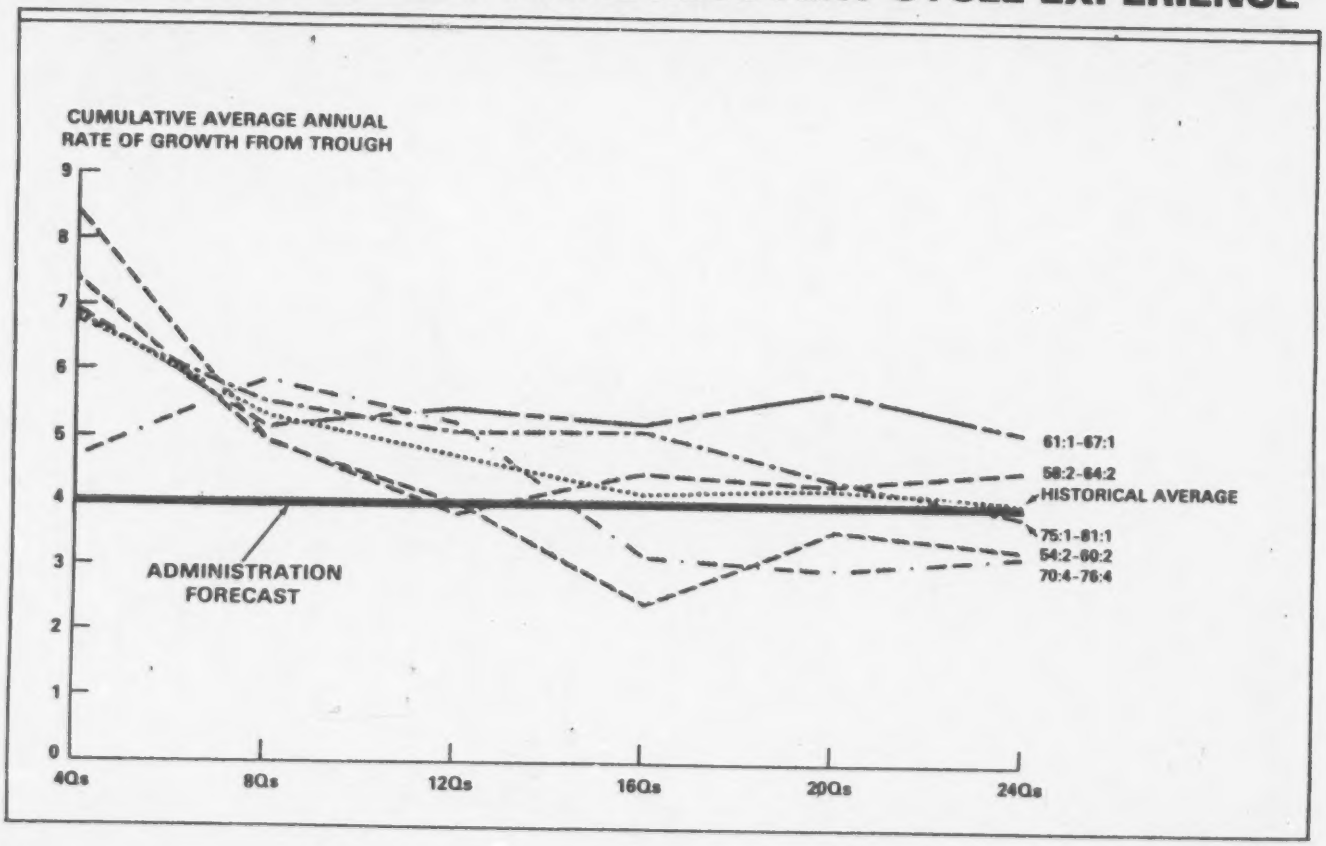
SIX-YEAR REAL GNP GROWTH FORECAST COMPARED TO HISTORICAL RECOVERY CYCLE EXPERIENCE



DIFFERENCE IN RECOVERIES

Senator PROXMIRE. Let me interrupt you at this point by pointing out that subsequent recoveries are going to be quite different. We have never had the kind of overhanging deficits that we have now. Those deficits will dominate the credit markets and make it extraordinarily difficult for the Federal Reserve Board to have any kind of anti-inflationary monetary policy that won't result in crowding out, thus holding down the interest-rate-sensitive parts of the economy. Isn't that right?

Mr. STOCKMAN. I think that is a risk, and one of the reasons why, at a minimum, we have to achieve these deficits. If we can do better, the prospects for the sustained recovery would be stronger. But the point I was making is that it is not outside the range of historical experience. We have a modest recovery that is lower than many people see in 1983, sustained longer than normal. But the thing that counts for the budget, which I am sure you appreciate, Senator Proxmire, is the level of GNP in the outyears. Whether you get there with a big spurt in 1983, less growth in the outyears, or another dip in the outyears doesn't matter. It is the level of GNP, and therefore the level of receipts and unemployment costs, that matter.

We think 4 percent growth, with a comprehensive deficit reduction program and political cooperation in the Congress, is a pretty reasonable assumption.

A 5-percent inflation rate is pretty reasonable if we can maintain a noninflationary monetary policy.

Senator PROXMIRE. Do you think that this is a reasonable inflation assumption for 5 years?

Mr. STOCKMAN. Yes.

Senator PROXMIRE. A "reasonable" assumption?

Mr. STOCKMAN. A reasonable assumption. We would like to do better but it is a reasonable assumption unless the Fed returns to 1970 style "reflation" and pumps up the nominal GNP and the money supply for 2 or 3 years at double-digit rates. Then we would go back to double-digit inflation.

NET PRIVATE SAVINGS VERSUS CREDIT MARKET FLOWS

Senator PROXMIRE. The reason I asked is that it seems to me the Fed may have to pump up the money supply or we are going to have an aborted recovery. On page 10 of your material, you indicate that the administration's proposed deficit for fiscal year 1984 is equal to 5.4 percent of GNP and will consume 94 percent of private savings. How can an economic recovery in the private sector take place when the Federal Government is consuming 94 percent of the credit if the Federal Reserve Board is going to follow the prudent policy that you and I advocate of not accommodating that crunch?

Mr. STOCKMAN. Senator, this is net private savings, not credit market flows. There is a big difference. In terms of what sustains activity in the short run, it is funds raised in the credit markets, which would be $400 to $450 billion in 1984. So that percentage is less than half.

What you have here is the new net savings on a GNP account basis that are available in the economy. That is a smaller number. For the long run, that is the only source of credit. For the short run, obviously there is a lot of cash available in the economy that the Government can use while others aren't demanding it.

So I would like to make that clear distinction. This is net savings on a GNP concept, whereas for the near term, you want to look at total credit market flows. It is a much bigger number, a much smaller percentage.

Senator PROXMIRE. Perhaps you are right, but it is still a big number.

Mr. STOCKMAN. You are right.

Senator PROXMIRE. And a big percentage.

CONTROLLABILITY OF FEDERAL BUDGET

I only have time for one more question. According to your Office of Management and Budget relatively controllable outlays for civilian programs under the President's budget would drop to 8.7 percent—less than 10 percent—of total Federal spending in fiscal 1984.

That compares with 11.2 percent of total outlays in fiscal 1981. Of course, this shifts the area of Appropriations Committee control over nondefense spending from tiny to microscopic, really. What would you call a desirable level of controllable nondefense spending as a percentage of the total budget? Do you have any figure in mind?

Mr. STOCKMAN. I do not know that you could manufacture one easily. I think what you are saying is that there is too little of the budget that is directly controllable.

Senator PROXMIRE. There is not much this committee is going to be able to do with the best will in the world.

Mr. STOCKMAN. I understand that. My presentation pointed out that there is $131 billion in budget authority for nondefense discretionary programs that this committee controls, either through lending limitations or through new budget authority enactment. That is small relative to a budget of nearly $850 billion. But $131 billion is not de minimis either. I think it is important that we do the best job we can of allocating it to the highest priority needs, but recognizing the problem has to be solved outside of the discretionary program area. It is entitlements, it is COLA's, it is what we do about revenues, and it is the level of defense spending that we finally choose, that will determine the basic shape of the budget. However, that shouldn't become an excuse for saying that discretionary spending does not matter, and we will just pump up the programs as various constituencies and interest groups see fit. I don't think we can revert to that posture, either.

Senator PROXMIRE. My time is up, Mr. Chairman.

Thank you.

Senator STEVENS. Thank you very much, Senator.

Senator D'Amato?

Senator D'AMATO. Thank you very much, Mr. Chairman.

Mr. Chairman, for the past 2 years, we have heard from the Office of Management and Budget a persistent drum beat proposing the elimination of operating assistance for mass transit. To date I have failed to see any documentation as to why this should happen.

We have had the drum beat of dogmatic rhetoric that it is bad to assist or to give to local communities the flexibility of using Federal assistance—a concept that we so often trumpet. In fact, Mr. Stockman, one of the cornerstones for the liberation of our towns, counties, villages, States, is the block grant formula. Isn't that correct, the block grant concept?

Mr. STOCKMAN. That is right.

Senator D'AMATO. Why is it that we are true to the philosophy of block grants, which inherently gives local government the ability to dedicate those moneys in the manner in which local government deems best and which can be most cost-effective, except when it comes to mass transportation?

Mr. STOCKMAN. Senator, I don't think we do.

If you look at the other block grants such as the chapter 1 Block Grant for Compensatory Education, we don't say to the schools: Go ahead, take it, put it in the general operating budget, and pay your teachers more with it. What we say is: Under relatively flexible conditions, here is your $3 billion to spend on low-income children for compensatory services beyond what you would otherwise provide.

We are making a distinction. The same is true in mass transit. We do not believe the taxpayers in Michigan, North Dakota, and Idaho ought to pay the fare box cost of New York City. It is that simple.

Senator D'AMATO. Let's talk about the fare box question in New York City. You know, it comes down to that. What I sense is the same drum beat that if we can identify this proposal with New York City, we can rally enough support to beat it. That is what has been going on. But the fact of the matter is that the New York City transit system receives no more than 10 percent of its operating budget from Federal funds for operating assistance.

When you get to the smaller communities the cuts that you propose will cut their budgets by some 82 or 83 percent. Some of them are dependent on operating assistance revenues for 25, to as high as 40 percent of their fares.

I see here a tragic disregard with what Congress did by legislating Public Law 97–424. Just flagrant disregard for that law, that legislation, which authorized 20 percent of the revenues for mass transit and set up a formula for distribution. You are now proposing a cut of 69 percent for operating assistance and its total elimination in 1985.

Mr. STOCKMAN. Senator, as you know, we have been advocating that for 2 years. Congress didn't appropriate the money. You authorized it. If we were to fully fund every authorization on the books the deficit would not be $200 billion, it would probably be $400 billion.

We have decided, as a matter of policy, that mass transit is an area of low priority for national funding in an exceedingly tight budget situation. If local people want subsidized rides, such as subway rides or bus rides, then local people should pay for them. It is that simple.

Senator D'AMATO. Let's look at the facts instead of, again, the rhetoric that we have heard before. It is New York City. It is the subsidies' inefficiencies. Do you think it makes sense to force a community to buy twice as many buses as they have ever had in any one year yet not allow them to hire mechanics to maintain them or sweepers; to not give operators that kind of flexibility because OMB says in 1985 that even a portion of your money can be used for operating assistance. The fact of the matter is that 83 percent of the operating assistance comes from local fare boxes and financing, not from the Federal Government. Only 17 percent comes from Federal sources, and you propose to wipe out that small amount of flexibility. I say to you, because the drum beat comes from you, the rhetoric comes from you, that we authorized funds, I voted for the gas tax bill and many other colleagues did, with the explicit understanding that we were going to allocate the distribution of these funds. Most of these revenues were allocated to small cities. You simply propose to wipe them out with a 69-percent cut in fiscal year 1984.

I wish you would look at the military budget a little closer. It seems to me you can make some really effective cuts there, instead of setting New York City up time and time again. I resent it. I think it is wrong. I think it is counterproductive. I am not going to sit by and watch you do it again. We will have the same battle again.

Senator STEVENS. Thank you, Senator. I cut you off there. You are on.

Senator HUDDLESTON. Thank you, Mr. Chairman.

ACCELERATION OF OBLIGATIONS FROM TRUST FUNDS

Mr. Stockman, we are talking a lot now about creating jobs and using Federal resources to develop job opportunities. We have in the Government a number of trust funds, I have identified about seven. They contain a substantial amount of funds. They have been collected on the basis of user fees or some other reason. The money is there. In most cases it is not earning any interest. Yet if we appropriate those funds we are increasing the deficit. That is, however, a different kind of a deficit than a deficit that has to be made up through taxation or some other form of revenue. It is a matter of our bookkeeping procedures I suppose. At any rate, is there any way that we can utilize those funds in such a way as to create jobs and perform needed work?

Have you given any thought to that?

Mr. STOCKMAN. Yes; we have, Senator. As a matter of fact, in the informal package that we have floated—I am sure you have had access to it—we have proposed precisely that. We propose to accelerate in 1983 the level of obligations of airport improvement grants out of the airport and airway trust fund, and for highways out of the highway trust fund, with a view that we would put more expenditures in 1983 and less into some outyears in order to stimulate the economy in the very short run.

We have recommended about $1 billion worth of acceleration from trust funds for transportation investment in 1983 in the discussions that we have had with various people on the Hill. If the bill comes over here, with the jobs component, I would certainly encourage you to pursue that direction. We can make it a true acceleration if we take it out of trust funds because if we raise the authorization for the obligations this year, we have to offset that in later years and not add to the multiyear deficit.

Senator HUDDLESTON. Use of all of these funds has been inhibited in the past simply because by doing so we increase the deficit. There is no question about that. On the other hand, they have been collected for a certain purpose. It seems to me that if they are not going to be used they shouldn't be collected. Leave the money in the private sector. Maybe they will hire some people with the money. It offers an opportunity and I am glad to see you moving in that direction.

We had a tremendous struggle in the last days of the lameduck session in trying to get some additional money from the mine reclamation fund. The money was there. The work was out there to be done. Yet if we increased the figure it would contribute to the deficit and run us over the subcommittee allocation.

Mr. STOCKMAN. We had a very large increase in the 1984 budget request, as I am sure you are aware, for that program.

GROWTH OF CUMULATIVE TOTAL DEBT

Senator HUDDLESTON. One other question. According to your figures the total debt as a percentage of the gross national product during the decade of the seventies, was running 35 to 40 percent, it goes to 46 percent in 1984, and projecting out to 1988 it gets to about 50 percent. This is the cumulative total debt. It is growing faster than the GNP? What effect will it have on economic growth and recovery of the economy?

Mr. STOCKMAN. It doesn't have a positive effect. I will say that. Whenever we divert private savings to fund the current cost of Government we are thereby diminishing the amount of investment for future productivity of the economy, future income of the economy. There is a cost to bond financing the Government, but unfortunately we don't have many practical alternatives that lead through the next few years.

Senator HUDDLESTON. Is there any kind of rule of thumb or model that indicates where we get into real serious trouble if the percentage of debt reaches a certain percentage of GNP?

Mr. STOCKMAN. No; I don't think so. That debt to GNP ratio is a little misleading. A lot of that debt is old. It is at a nominal value that is very low compared to current dollars. You need to look at current deficit versus current credit market or current national savings. The debt-GNP ratio is something to be concerned about, but I don't think it is a very meaningful measure of the economy.

AGRICULTURAL LOAN PROGRAMS

Senator HUDDLESTON. Mr. Chairman, if I have time for another question, in the agricultural segment, the payment-in-kind program that is being initiated still has an unsettled tax question. Do you anticipate that is going to be resolved?

Mr. STOCKMAN. I hope so because we think it is critical that this program works to reverse the devastating cycle of rises, production, and stock that we have in all the basic commodities. I can't give you any detailed information today on the disposition of that. But certainly we are strongly behind it and we will do everything we can to encourage the right ruling.

Senator HUDDLESTON. I don't have time to get into it in detail but here again is a question of bookkeeping. Most of our farm programs deal with outlays; in most cases they are loans. In many cases they do not result in any cost to the Government. But at the same time, we are inhibited in our use of them.

Is there any thought there of doing something about the bookkeeping system?

Mr. STOCKMAN. Senator, I do not subscribe to the theory that the CCC is really a bank for agriculture; that it just makes loans that are always repaid. But if that is the case, why have we spent $40 billion in the last 4 years out of the CCC? There is no prospect that we are ever going to get that back because a lot of the loans have defaulted. Other parts of the outlays have been interest which we never recover, losses which we never recover, or deficiency payments which are outright grants.

Senator HUDDLESTON. The way to get it back is to make use of the asset that you have for the loan, that is the commodity.

Mr. STOCKMAN. That is precisely what we have proposed. Once those expenditures have been made, we have all those crops under loan. It occurred to us that it was far more desirable to spend assets we already have to encourage production restraint in order to rebalance the market than to offer up new cash for new programs that would only make the underlying economic situation worse. So we think it is critical that this PIK program get off the ground.

I might add—I know this won't go over well with some from the agricultural areas—we must freeze the target prices in conjunction with the PIK program. As long as those target prices keep going up, anything that we get by way of set-aside in production restraint temporarily will be offset by incentives for production, planning by rising target prices. If we are to get this agricultural market back in balance—get the Government out—then we have to implement both the freeze and the PIK support to the individual producer.

Senator HUDDLESTON. I heard the bell. I am sure my colleague will respond to that.

Senator STEVENS. Senator Andrews.

Senator ANDREWS. We could have all kinds of fun with this one, Dave. It is good to have you here.

I am amazed at the quantity of your knowledge. You have got to have the knowledge about everything from sweeping out New York subway cars to PIK programs out on the farm. Every now and then there are bound to be a few things falling through the cracks. Obviously the reduction in acreage PIK brings about, increases the prices which it is designed to raise.

You said a moment ago you won't have the exposure under the target prices and you don't really have the need for the lower payments because you won't be paying deficiency payments. That is the way we understand the program.

I believe your second statement is incorrect. However, I hope that is not the case with your first statement. To get to another part of the farm program, the nutrition side, what evidence do you have that we are spending too much money on the child nutrition program? Do you have solid evidence of that?

Mr. STOCKMAN. I don't think we are spending too much money on child nutrition or a lot of other programs. The problem is that, in the aggregate, there aren't the resources in the budget to fund each of these programs at the level that might be justified purely on merit or purely on the program issues involved. If you look at child nutrition, we have proposed no major changes in the school lunch program. We have proposed to fund WIC at $1.1 billion, which is the same level we appropriated last year.

The only area where we are proposing a change is in three subsidiary programs: The school breakfast program; the summer feeding program; and the child care support that goes to day care homes.

Senator ANDREWS. In fact, Dave, the school breakfast program was $327 million last year, child care food program, $332 million last year, summer food program, $99.4 million for fiscal 1983. You are wanting to put in a block grant with a 29-percent reduction over current expenses. You know, we are cutting back production on the farm because it is not needed. However, food and nutrition programs are needed in the cities. The New York Times had an editorial last Sunday. One of the things that they pointed out was that poor nutrition can result not only in infant death, but in physical disorders, mental retardation, and so forth, which seems foolish to allow, because getting a WIC recipient through her pregnancy costs in the neighborhood of $450.

Taking care of a sick baby through a neonatal unit costs the Government $40,000. That is not economy. I agree with the president of Tufts University when he pointed out that the dumb way is saving money and not feeding kids. We have a surplus of food in our country. We are trying desperately to get rid of it. You are short-changing the feeding programs that can result in massive savings down the line. Do you call that an intelligent approach in saving money?

Mr. STOCKMAN. I would. I think you have offered some interesting facts but not a very complete analysis.

It is true that some of the nutrition programs have helped to improve things such as infant mortality, child health, and so forth. But there is no demonstrated connection between a level of funding of $600 million for breakfasts and summer feeding, or $400 million, and any significant variable of child health or welfare that I can think of.

I think the more important point to remember is that we have nearly $16 billion in this budget for nutrition programs. In 1970, we had $1 billion for all nutrition programs, including food stamps. Even if you take out the inflation, there are five times more resources in real terms for nutrition in this budget—even with this little $200 million change that you are talking about—than we were spending a decade ago.

My point is that we are doing much more to effectuate the theory that you have just articulated. That does not preclude finding a few areas where you can question expenditures in terms of how much good they are doing.

Some are feeding programs. You know that they have been wrought with scandal. The child care home feeding program is not even means tested; anybody could get it. We are proposing to cut down that part of it.

IMPORTANCE OF NUTRITION PROGRAMS

Senator ANDREWS. You are talking about the fact you are throwing money at programs. I am talking about solving problems. You have got tens of thousands of young, pregnant women out there, getting less than adequate nutrition.

You are telling me that because we are throwing a lot of money out, we should overlook the fact that tens of thousands of people simply aren't being served!

Damn it, we have been in office for 2 years. It is about time we started cleaning up those programs and not point the finger and say money is being wasted, therefore the way to solve it is to cut back spending.

The thing we have got to do is make sure as long as thousands of people are out there, undernourished, that we address the goals to these programs. We should clean up the waste. If we are throwing $100 million down the rat hole, let's correct it. But please don't claim that the need isn't there.

I have gone to some of these inner-city feeding areas in Washington, probably the only Senator that goes to them without TV cameras, and I know the need is there.

I have seen people scrounging around in the dumpsters in the public market. Church volunteers are trying to get enough money and food to feed these people. I sat in that lunch next to a Woodward & Lothrup retiree, and I discovered he needs a volunteer food program, otherwise he would go hungry.

There is not 1 pound of Federal flour, pasta products, or potatoes that goes to these people. It is all done on the volunteer basis. It is a shame because our so-called money changers in the temple say we are spending too much money and the need isn't there.

Go see for yourselves where the need is. Redesign some of these programs; let's meet the need. If we are wasting the money; let's clean up the waste. But after 2 years in the office, it is inexcusable that we sit there and say there is no need.

Mr. STOCKMAN. I did not say there was no need. I was pointing out the huge magnitude of the need we are serving. I would point out that in WIC there are 12 percent more people served by this budget than in 1980. That is doing something.

I would suggest to you that if we need to provide more money in the instances you have described, why don't we cut out the 20 cents that goes to upper-income kids in the school lunch program and distribute that amount of value either to mothers and children who are not being served in the cities or to the retiree that you are talking about who doesn't have enough nutrition?

Senator ANDREWS. You need some imagination and basic sense, and maybe some humanitarian instincts. We could put some of these commodities out there on the farm waiting for a place to go into some volunteer feeding programs.

Mr. STOCKMAN. We are doing that right now.

Senator ANDREWS. Very little that I can see.

Mr. STOCKMAN. Several hundred million dollars.

Senator ANDREWS. I haven't seen anything from the Department of Agriculture, anything from the OMB that would indicate this. I have exceeded my time. I hope that we can get away from this business of treating these kinds of needs as dollar signs and say because some money is wasted there is no need out there. That isn't the case at all. It is something we should address our best thoughts to.

Thanks, Mr. Chairman.

Senator STEVENS. Senator McClure?

Senator MCCLURE. Would you like to respond on my time?

Mr. STOCKMAN. Yes; I would like to say it is very frustrating, because if you look at this whole set of programs maybe you can find cases where we are missing people in need. I am not denying that. But literally we found——

Senator ANDREWS. Not some, but many. That is tragedy.

Mr. STOCKMAN. I am saying that this is a collective program, a collective responsibility. We fund 95 million meals a day in the Federal programs. That is an enormous amount of support available through school lunch, school breakfast, food stamps, WIC, commodities, summer feeding, school milk, and special milk programs.

If we are not hitting people with need, then there is something wrong with this large conglomeration of $16 billion worth of programs. We in the administration and you on the committee, especially someone with your knowledge of these programs, ought to do something about it.

I cannot believe with that kind of money and 95 million meals a day funded that we cannot do a decent job of hitting people that aren't being covered.

ADMINISTRATION OF FOOD STAMP PROGRAM

Senator MCCLURE. First of all, I want to commend you for a budget approach that for the first time in my judgment begins to address the real problem that we have; that is the growth in the entitlements programs.

I appreciate that new trend. I recognize the difficulty in getting there. I also recognize the difficulty of getting the Congress to agree.

I might just make one passing comment with respect to the question that Senator Andrews has raised, the issue that was raised, and make a parenthetical statement. More than that perhaps.

The food stamp program is the most maladministered program in the history of this Government in my opinion. I think every objective analysis of it says that it is not simply meeting the need that was identified, it is doing much more than that.

I remember one time I offered 26 amendments on the floor of the Senate and got 1 adopted out of the 26 and every one of them was addressed at some waste or abuse or overpayment or lack of direction in that program. They have not yet been corrected. They have not been corrected in the main because the Congress prevented their correction. So the problems are as Senator Andrews correctly identifies.

It is not just the administration's fault. It is the fault of the Congress that won't curb the abuses in the food stamp program. I say that not because any of us want to avoid getting commodities and food to the people that really need it. But there are an awful lot of people that are beneficiaries of that program that are not really or should not be really the objects of public welfare.

You mentioned the school lunch program; the relationship between the school lunch program and the food stamp program as an example.

The food stamp program is supposed to set up a nutrition budget for families. That is supposed to cover the minimal nutritional needs. But it does not consider the amount of food that is given to the family through the school lunch program.

Mr. STOCKMAN. Or the WIC program or commodities distribution.

Senator MCCLURE. Why shouldn't it? It ought to. If it did, that amounts to millions of dollars of savings out of a program that has grown far more rapidly than the reduction in the program Senator Andrews made reference to.

I want to ask a couple of other questions.

HIGHWAY PROGRAMS

On page 6 of your statement, you show down in the highways, 56-percent increase and if I understand that correctly, that is prior to the passage of the gas tax legislation.

On page 31 of your table on transportation an appropriate bill under the highway trust fund shows that up 9 percent.

Mr. STOCKMAN. The reason for that is that it only covers the appropriated highway funding and not that which comes from the trust fund that is controlled with an obligation limit. That is the reason for the difference.

Senator McCLURE. So the obligation limit is out. This covers the——
Mr. STOCKMAN. The nontrust funded highway programs.

TIMING OF JOBS PACKAGE EFFECTS

Senator McCLURE. On your jobs package, I would understand the philosophy of the jobs package is to put additional money into programs where they will translate into jobs quickly.

Is that correct?

Mr. STOCKMAN. That is correct.

Senator McCLURE. How are you making certain that it translates into jobs quickly? I have been in Congress a number of years now. Every time we have had a jobs program, instead of working countercyclically, it works right on the cycle. It provides the jobs right at the peak of the next business cycle rather than at the valleys. How are you going to make sure this translates into jobs now?

Mr. STOCKMAN. That is a very good question. Your point underscores the reason why we would oppose a freestanding local public works act or emergency jobs act: because history clearly demonstrates that by the time you get the bill passed, the regulations written, the applications received, processed, and awarded, and the money out in the field for construction work, the spending hits the economy at precisely the wrong time.

The way to safeguard it is to take money that is already in the budget for 1984 or 1985, spend it in 1983, obligate it in 1983, but reduce the funding by an equal amount in 1984. That will have a level effect on the economy, rather than the impact that we have experienced in the past when we have created a new program, put new money out, and had that new money hit at the wrong time.

USE OF EDA TO CREATE JOBS

Senator McCLURE. If I might follow up with one question, Mr. Chairman, I understand that philosophy. But I am concerned. I look down the list of the jobs package. There are aggregate sums of money there that in my judgment, tell me there are not that many contracts that are ready to let, to put people to work this summer. That is what you are aiming at.

Mr. STOCKMAN. That is right.

Senator McCLURE. At the same time, you have cut off something like EDA, sewer grant program, for example, in which EDA sometimes participated and those jobs come to a close because you are running out of money. So you are laying off men in an area where jobs are ongoing while you are trying to start up jobs in another area by infusion of money into an area where jobs are not really ongoing.

Mr. STOCKMAN. I do not think I quite agree with that. We have been in a shutdown phase on EDA for 2 years now.

Senator McCLURE. There are still contracts being performed?

Mr. STOCKMAN. That is right. We tried to finish the projects that were underway in 1981, but we have awarded no new projects.

Senator McCLURE. How about enough money to complete them?

Mr. STOCKMAN. I think we have pretty well funded what was in the pipeline.

Senator McCLURE. That is not true. If I show it was not true, would you entertain the possibility of putting enough money into EDA to fund the ones that are already underway?

Mr. STOCKMAN. It depends on what your definition is because there are a lot of projects that can also have a phase 2, phase 3, or phase 4 that was never contemplated in the original award.

Senator McCLURE. If I can meet that criteria.

Mr. STOCKMAN. I would be very happy to talk to you about it.

Senator McCLURE. Thank you. I can show you contracts for which there have been escalation of costs for a variety of factors, they are going to terminate the contract before it is finished because they run out of money. Those are jobs that are in being, they are jobs that will be, workers that will move to the unemployment side of the table unless there is enough money there to complete the contract. They are not phase 1, phase 2, phase 3 add ons.

Mr. STOCKMAN. We have proposed to defer $158 million. I am sure that you may well decide that some of that is needed in order to finish these projects that are ongoing and now underway.

Senator McCLURE. I appreciate the thrust of the effort. I will cooperate. I really am. I am concerned about setting up a program to put people to work that will never get there this year. It will be 2 or 3 years from now before they are fully employed on the contracts that have to be formed, let, and sometimes projects that have to be decided while we are laying off people that are in the middle of the construction program that is ongoing but uncompleted. That does not make any sense.

Mr. STOCKMAN. No; I agree with that.

This list that we have certainly can be refined and perfected. A major goal, I believe, ought to be to take money out of the 1984 budget and move it into 1983 where it can be obligated in a reasonable period of time.

Senator McCLURE. An extension would not do because we do not plan to have it in 1985. I understand.

Senator STEVENS. On behalf of the Chair, Mr. Stockman, we want to thank you for coming. We want to express thanks to your staff who are seated behind you.

It is fairly obvious, to this Senator at least, that I am looking at a new David Stockman. I see David Stockman recommending things that the Senate restored last year and a little more in the spirit of conciliation and cooperation.

I hope that this is beginning a good year.

I say you will need all the love and affection of that young lady that you can get. It is a tough year. [Laughter.]

Thank you very much, David.

SUBMITTED QUESTIONS

The chairman obviously isn't here and there are a series of questions that have been prepared by him and for him. I will see to it that you get the questions he wanted to ask you.

There are times when my good friend from Oregon and I are not exactly coming from the same direction. So I don't want to change his questions. I would rather submit them to you if that is agreeable.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY CHAIRMAN HATFIELD

Target Deficit for 1985

Question

A very large group of prominent Americans, including several former Treasury Secretaries, has argued that the Administration's plan to reduce projected deficits in FY85 to $194 billion is not sufficient. They believe a reduction to about $75 billion is required to restore confidence in the economy and assure a recovery. What is your reaction to this proposal?

Answer

I believe the first critical step in this year's budget process is to enact the deficit reduction proposals already proposed by the Administration. That in itself will be difficult to do. Once we have achieved these reductions, we can debate the merits of additional deficit reduction measures, such as those proposed by the former Treasury Secretaries and others.

Federal Borrowing and Total Funds Raised

Question

During the 1960's, federal borrowing as a percent of total funds raised in U.S. credit markets was about 8%. This figure rose to 15% in the 1970's and 19% in 1981. What was the 1982 figure, and what estimates can be made for 1983 and 1984? Ideally, what percent of total funds raised should the government consume, and how do we get there?

Answer

Federal borrowing was 33% of total funds raised by nonfinancial sectors in U.S. credit markets in 1982. Total funds raised is a volatile series, and OMB does not currently forecast it. However, because Federal borrowing from the public in 1983 and 1984 is estimated to be 50% or more higher than it was in 1982, borrowing is expected to be a very large percentage of total funds raised in both years.

Federal borrowing is determined primarily by the total Federal deficit (including the deficit of the off-budget Federal entities). Therefore, the ideal percentage of Federal borrowing relative to total funds raised depends on the ideal size of the total Federal deficit. This Administration has repeatedly supported a balanced budget, which would mean that the Federal Government would use approximately none of the total funds raised. As stated in the recent Budget Message of the President, "we must ensure reduction and eventual elimination of deficits over the next several years." We cannot move to a balanced budget immediately, but the budget program presented to the Congress reduces the deficit substantially by 1988 and puts fiscal policy on a path consistent with economic recovery and long-term budgetary equilibrium.

Balanced Package of Budgetary Proposals

Question

You were recently quoted in the Wall Street Journal as stating before another congressional panel that it is impossible to reduce the deficits through raising revenues or cutting defense spending. Is this an accurate statement?

Answer

In a recent hearing before the Senate Budget Committee, Senator Sasser asked what the Administration was going to do about the large structural deficits projected in the years ahead. I responded that:

> ". . .there are no miracle cures. You cannot do it by taking 25 percent of GNP in taxes or dismantling the Defense Department. There are a lot of entitlement and domestic programs, but you cannot do it all there and you cannot do it by assuming 6 percent growth for six years. So you have to have a little bit of all of the elements put into a package that is consistent with the basic objective that we have in this country of slowing the growth of government, keeping the tax burden down, and having secure national defense."

The essence of my response to Senator Sasser is that a balanced package is needed to address the large structural budget deficits projected in the years ahead. I recognize that others will suggest different proportions for defense, tax, and nondefense proposals, but I do not believe that any one area can be singled out alone to solve the large problem we face.

DEBT COLLECTION

Question

The Administration has taken an aggressive approach to collection of debt owed the Federal government. How has actual debt collected compared with administration projections for FY 82, and so far in FY 83? What impact will the Debt Collection Act of 1982 have on the government's ability to collect its debt? Are there any concrete figures yet in reflecting the impact of the 1982 law?

Answer

At the beginning of FY 82, we projected that the administrative initiatives that were already underway in the agencies would increase collections by $1.5 billion. Throughout FY 82 we monitored agency debt collection activities using a revised quarterly reporting system initiated by the Treasury Department in October 1981. An analysis of final FY 82 data collected under the system indicates that as a result of the improvements made by the agencies, $2.1 billion more was collected in FY 82 than would have otherwise been collected in the absence of the administrative improvements.

For FY 83, we project that collections will increase by $2.8 billion. We have not yet completed our analysis of first quarter collection data for FY 83, so we cannot determine where we stand in relation to the $2.8 billion goal.

The recently enacted Debt Collection Act of 1982 will have a significant impact on our efforts to increase collections. The legislation will revolutionize Federal credit management and debt collection practices by giving Federal managers many of the same tools and techniques used effectively in the private sector. Because the legislation is not yet fully implemented, we do not have any concrete figures which reflect the impact of the law on collection activities.

Question

In their report of October 18, 1982, the President's Council on Integrity and Efficiency (PCIE) reported potential savings of $5.8 billion resulting from audit recommendations to recover funds, improve system controls, and increase government efficiency. What steps have been taken to implement these recommendations and how much of the projected $5.8 billion has been saved?

Answer

The second half of fiscal year 1982 report of the President's Council on Integrity and Efficiency (PCIE) reported that "six months savings and improved use of funds amounted to $5.7 billion."

Eighty-five percent of the total financial benefit ($4.85 billion) were in the "costs avoided" category, i.e. "estimated amounts that will be avoided as a result of management's commitment to implement Inspectors General's recommendations." Of that sum, 62 percent ($3.04 billion) fell in the category of "reductions in negotiated prices of contracts before awarded" and had therefore been largely implemented and saved before the report was issued. Another $250 million was comprised of the additional interest income which would accrue to the USDA Grain Reserve Program. The remaining $1.56 billion was made up of hundreds of separate commitments scattered among the reporting agencies. Examples of these are provided on pages 20-22 of the Summary Report.

Fourteen percent of the total financial benefit, ($795 million) were in the "management commitments to seek recoveries," category. Examples of these are provided on pages 23-25 of the Summary Report. $296 million were reductions which management committed to negotiate in final contract prices -- to achieve the saving the government had only to reduce the final payment to the contractor. $85 million were management commitments to recover advances in Guaranteed Student Loans. The remaining $413.8 million were, again, scattered among the reporting agencies.

In sum, $3.3 billion of savings ($3.04 billion of pre-award recommendations and $296 million negotiated post-

award payments) were achieved or assured through the contract administration process and did not become debts owed to the government.

The remaining amount ($2.38 billion) was a mixture of debts, actual recoveries, and agency commitments to improve the use of funds.

Follow-up on debts is now being monitored and reported for the first time. As a result of the issuance of OMB Circular A-50 on September 29, 1982 and one of the cost reduction initiatives of Reform '88, we have required agencies to:

- o book these amounts as receivable as soon as management has agreed to seek recovery
- o start charging interest within thirty days to discourage fivilous appeals
- o report the amount of audit disallowances collected each quarter (the amounts will start appearing in the next Summary Report of the PCIE)

In addition to the special emphasis being given to management effectiveness and follow through, it is standard practice for the Inspectors General to look into these issues again when making subsequent reviews or audits of the same programs or activities.

Outer Continental Shelf Oil and Gas
Receipts for 1983

Question

The Administration originally predicted $18 billion in revenues from Outer Continental Shelf leasing for FY 83, but subsequently reduced this to $15.7 billion. Currently, what figure is projected for OCS leasing revenues?

Answer

The current budget estimate for 1983 OCS oil and gas receipts is $11.8 billion.

The $18 billion estimate for 1983 originally published in the 1983 budget was based upon a 5-year OCS program then in the process of being developed. That program was approved by Secretary Watt on July 21, 1982.

The program makes changes designed to achieve early exploration of OCS areas with oil and gas promise while protecting OCS values other than oil and gas resources. One of these changes will be to consider entire planning areas for potential lease offering rather than to plan very highly selective lease offerings. This new approach significantly but temporarily increases the

uncertainty about the receipts outcome of such sales. Since area-wide sales have not been held in the past, there is no history of how the industry will respond to such lease offerings. Very large potential reserves will be offered. Clearly industry will take only the most promising fraction of the reserves offered in each sale. Our estimates assume that very conservative fractions of the reserves offered will be leased, but those estimates may be either too large or too small. Without previous experience of such sales, estimating is extremely difficult. The current estimate makes somewhat more conservative assumptions about the result of such sales than last year's budget estimate did.

The current estimate is also smaller than last year's $18 billion estimate because:

- an additional year's time in collecting and analyzing geological information about sale areas has passed. Some sale area estimates are much smaller because exploratory drilling has proven to be unsuccessful.

- the current outlook for world oil prices in real terms suggests much lower near-term prices and somewhat reduced rates of future growth in real oil prices. These factors tend to reduce both royalty and bonus estimates.

- the $18 billion estimate assumed $1.5 billion in escrow payouts resulting from the completion of litigation about the distribution of certain receipts pursuant to section 8(g) of the OCS Lands Act. Because of delays in this litigation, the current 1983 estimate does not contain any assumed escrow payout.

Budget Specifics
Property Review Board

Question

According to the Property Review Board the sale of 60,000 acres of unneeded Federal property would generate $1.2 billion in revenues in 1983. How much of this property has been sold to date, and does it appear that the $1.2 billion goal will be met by the end of 1983?

Answer

The $1.2 billion revenue target was developed when the President's 1983 budget was prepared. Since that time the Property Review Board has been established, and has focused on estimating more precisely the potential universe of properties that could be made available for disposal. As a result of this assessment, the following revenue estimates have been projected in the President's 1984 budget:

	($ in millions)					
	1983	1984	1985	1986	1987	1988
GSA	442	639	526	549	429	387
Interior	7	225	260	294	324	350
Agriculture		200	200	200	200	200

Sale of GSA and Interior properties can be made under current authority. The Administration will propose legislation to provide new authority for sale of lands held by the Department of Agriculture.

In terms of property sales already conducted, GSA has made significant progress. Although the Property Review Board was not established until mid-year in 1982, GSA sales increased in 1982 to $105 million from a historical average of $60 million annually.

Slowing Defense Procurement

Question

Murray Weidenbaum recently argued that we should slow down defense procurement for national security reasons. He showed that most procurement programs which are reduced in quantity are those that experience significant cost overruns. His conclusion was "Slowing the growth rate of defense spending to conform more closely with production capabilities will both reduce the deficit and make more likely the successful completion of the military buildup. Rather than choosing between national security and economic factors, the two may go hand in hand." What is your reaction to this view?

Answer

I agree that defense procurement should conform with existing or projected production capabilities; however, since there is now excess defense production capacity, I cannot agree that there is any need to slow defense procurement because of capacity limitations. There are no significant production bottlenecks or capacity problems expected that would hamper the current rate of build-up. In 1979/1980 there was real concern about bottlenecks, lead-times and capacity as orders for both the military and civil segments of the aerospace industry were rising and competing for some of the same resources. Currently, however, lead-times are substantially reduced and the excess capacity of the aerospace industry is well documented. Current defense production orders should maintain and create jobs and help stimulate recovery from the recession by utilizing readily available manpower and capacity.

DOD Acquisition Initiatives

Question

CBO's re-estimate of the defense budget indicates that the cost of 60 major defense procurement programs has escalated by $2.6 billion in the FY 84 budget. These increases reflect higher estimates of costs per unit in real terms, after adjustments for inflation. This

Administration instituted a number of initiatives to restrain cost growth in major defense purchases. In light of these figures, can this program be judged a success?

Answer

The Department of Defense's acquisition initiatives represent a major institutional change in the way Defense does business. Any effort of this kind will necessarily take some time to accomplish. However, Defense does anticipate over $17B in savings from such efforts as multiyear procurement, increased competition and other improved procurement practices over the FY 1981-FY 1988 period.

A significant cause of the $2.6B in cost growth identified by the CBO is reduced weapon system procurement quantities from that planned in the 1983 budget. These changes result from a variety of factors, including competing requirements, reassessments of need, technical problems or the previous year's Congressional action. While improving program and funding stability may be difficult to achieve, it remains an important objective.

Senator Nunn Reporting Requirements

Question

Senator Nunn sponsored legislation establishing reporting requirements when cost overruns reached certain percentages. What has been the impact of this legislation on DOD? Has it slowed cost escalation, or resulted in scaled-back purchase plans?

Answer

The Nunn Amendment has helped to focus management attention within the Department of Defense on cost estimates for major weapon systems. It has given greater visibility to problem areas and has resulted in cost reassessments for the F-15 fighter aircraft, the Patriot air defense system and the DSCS-III communications satellite program.

DOD Economical Production Rates

Question

CBO lists three DOD procurement programs as being affected by greater than 50% unit cost escalation between February 1982 and January 1983. These are the Maverick missile (95% increase), the MX missile (79% increase), and the SH-60B helicopter (59% increase). What is the cause of these extraordinary increases? Do

the figures represent strictly a reduction in the numbers ordered, elevating the per unit price? If so, isn't this inconsistent with the Administration's announced goal of cost savings through more economical production rates?

Answer

The unit cost increases shown in the CBO report for the M-X missile, the SH-60B helicopter and the laser Maverick missile reflect not only changes in quantities but also program rephasing in response to Congressional and Defense Department actions. For the M-X missile the cost changes are a result of changes in the basing mode and a rephasing of the missile buy. The Air Force still anticipates that program goals will be met and the missile's real unit costs over the life of the program will remain constant. For SH-60B helicopters and laser Maverick missiles, the unit cost increases reflect primarily slower buildup in production rates in response to Congressional FY 1983 budget adjustments and better cost data. Both Congress and the Administration need to work together to improve the prospects for more economical buys of weapon systems.

Foreign Assistance Levels

Question

Once again, the Administration is placing what I believe to be an overemphasis on foreign assistance at the expense of economic and humanitarian aid. For example, UNICEF, which was provided with $42.5 million in fiscal year 1983, is slated for $27 million in fiscal year 1984, and the American Schools and Hospitals Abroad program of the Agency for International Development is in the '84 budget for $7.5 million as compared to an appropriation in the current fiscal year of $20 million. These reductions have been placed at the door of OMB and the general justification has been that these reductions are being made for "budgetary reasons". Such an assertion, frankly, is absurd in face of the hundreds of millions of dollars of increases being recommended for military assistance. How can we take the Administration's arguments seriously with respect to budgetary constraint in view of the growth of military assistance and the defense budget?

Answer

The President's 1984 request for foreign assistance represents the minimum amount required to meet the variety of security, foreign policy, economic, and humanitarian objectives of the United States.

It is correct to say that, since the Reagan Administration took office, the "international security assistance" portion of foreign aid (budget subfunction 152) has grown faster than the development and humanitarian aid portion under the heading "foreign economic and financial assistance" (budget subfunction

151). This growth was necessary because, by almost any standard, security assistance programs were seriously underfunded in the previous administration. The increases have been directed at objectives that a large majority of Americans support strongly:

— promotion of a lasting peace in the Middle East;

— protection of vital oil supplies and other U.S. interests in the Persian Gulf;

— support, primarily economic, for the countries of the Caribbean Basin area; and

— aid to nations facing direct Soviet threats and intimidation by Soviet client states.

The Administration is proud to have responded to critical foreign aid needs in these areas, and applauds the congressional support it has received. More needs to be done to correct past deficiencies, and I urge enactment of the proposed $723 million in supplemental foreign aid funding requested for 1983.

Once underfunding is corrected, the Administration seeks a balanced program of concessional security and development aid. For 1984, the rate of increase for the two components is about the same. Setting aside offsetting receipts which do not finance new programs, security assistance grows at 3 percent over the requested 1983 amount, and development aid will grow at 2.9 percent. For the outyears, most programs are currently held level with some changes due to external factors, such as a decreasing flow of refugees from Southeast Asia and the desirable paying off of arrearages to the multilateral development banks.

Within these program categories, the Administration has tried to use foreign aid funds in the most effective manner possible. Thus, for the American Schools and Hospitals Abroad program, which in the aggregate is less directly related to the most pressing needs of developing countries than other activities, the Administration seeks for 1984 the same amount it sought in 1983, $7.5 million, rather than the $20 million appropriated. For UNICEF the Administration seeks only a slight increase above the 1983 request, preferring to rely more on bilateral aid to meet humanitarian aims.

Foreign Operations
International Monetary Fund

Question

Under the Foreign Assistance request, by far the largest departure from current levels is the Administration's request for funding of the International Monetary Fund's quota increase. This request will amount to approximately $8.5 billion, and while there are no outlays scored against this

item, the budget authority increase is significant in that it would increase function 150 by more than 50 percent. Some members believe that the quota increase should be sent up as a fiscal year 1983 supplemental rather than as part of the fiscal year 1984 budget. My understanding is that the authorizing committees have nearly completed their hearings and I believe Senator Kasten has indicated that he will finish hearings on the IMF well in advance of consideration of the supplemental.

Therefore, we could avoid the added burden of the overall '84 budget fight by sending this up as a supplemental. What are your thoughts on this suggestion?

Answer

We agree and we are sending up the proposals for increased funding of the IMF as a 1983 supplemental.

Scientific and Research Funding at NSF, NOAA, and NBS

Question

The Administration is proposing a substantial funding increase for the National Science Foundation. At the same time, other scientific and research agencies, such as the National Oceanic and Atmospheric Administration and the National Bureau of Standards, are facing large cuts in fiscal 1984. On what basis were these choices made? Are the various scientific and research budgets of the Government subjected to a uniform analysis or are they considered individually?

Answer

The scientific and research budgets of all Government agencies are analyzed in the context of agency mission and the Administration's overall economic and science policies. Generally, R&D funded through a mission agency, including basic research, is intended to help that agency meet its mission objectives. The level of funding proposed for the R&D programs of a mission agency depends on such considerations as:

- The relative importance of an agency mission in the context of the overall priorities of the Federal Government.
- The effectiveness and efficiency of R&D as a means of meeting mission objectives.
- The appropriate role of the Federal Government in supporting those activities. For example, investment in near term commercial research and technology development would be considered a funding responsibility of the private sector and not the Federal Government.

In keeping with this policy, the proposed reductions in NOAA and NBS are specifically targeted at R&D activities in areas of applied research and development such as fisheries and aquaculture development, building research, automated data processing standards, and fire standards research and engineering, which, in our view, can

and should be supported by the private sector. These proposed reductions parallel similar reductions proposed by the Administration in other program areas particularly in the support of energy technologies and also in aeronautics R&D.

However, in addition to funding appropriate R&D activities (including basic research) to meet specific objectives of mission agencies, the Federal Government also supports research that is in the broad national interest and unlikely to be supported by the private sector—to assure long term technological and economic strength. The support of basic research through the National Science Foundation falls into this category. The proposed increase in the NSF budget, almost all of which is for the support of basic research, reflects the Administration's view that such support is important as an investment in the Nation's future technological strength and economic growth and is an appropriate responsibility of the Federal Government.

Budget Specifics
Standard Level User Charges (SLUC)

Question

Various agencies of the government are again facing large Standard Level User Charge (SLUC) increases in fiscal 1984. For instance, the Federal Communications Commission SLUC increase amounts to more than 50%, from $5.8 million to $9 million.

1) For those agencies in which fiscal 1983 increases were denied or modified by Congress, do the SLUC increases assume the 1983 base as enacted into law or as proposed?

Answer

The SLUC amounts for 1983 shown in the President's budget are the amounts that were enacted by law.

2) Given the fact that the Federal Government is facing extreme budget constraints, does it make sense to further penalize agencies by sharply increasing their SLUC fees, which are merely a transfer of funds from one area of the government to another?

Answer

The philosophy under which the SLUC fund was established is that agencies will pay into the Federal Building Fund (FBF) rents that are the equivalent to commercial rates for the space used. The income derived from SLUC is deposited into the FBF and provides the source of funding for all direct Public Building Service programs.

Some of the 1983-1984 increases appear to be large for two reasons:

- the proposed SLUC increase to cover higher costs in 1983 was denied by the Congress, so the increase shown is really a two year jump -- from 1982 to 1984; and

- the normal three-year reappraisal cycle which forms the basis for SLUC assessments has taken place and will affect many properties in 1984.

The increase to market rates in 1984 is necessary to ensure that agencies recognize that space charges are a true cost of operation -- space is not a free good. In addition to encouraging performance budgeting by providing dollar incentives for improved space utilization, the SLUC process establishes a businesslike landlord/tenant relationship between GSA and occupant agencies, enhances oversight of space-related activities and improves building operations and services. Further, the cost to GSA of the space is continuing to increase and, except to the degree that it can be offset by more efficient utilization of space, must be paid by the Federal government. The users of the space are the proper ones to pay this cost.

For fiscal year 1983, the Congress imposed a freeze on the rates that could be charged agencies under the SLUC system. Specifically, rates could not exceed those charged in 1982.

Should the congressional freeze level be maintained in 1984, there would be no new construction program ($133 million including funds for the Bonneville Power Administration headquarters building and a new federal office building in Knoxville, Tennessee), no repair and alteration program ($200 million) -- work required to prevent deterioration and damage to buildings -- and lower than required funding (of approximately $53 million) for other obligations such as rental payments to landlords.

Federal Credit for Small Businesses and Farmers

Question

A primary goal of the Administration is to reduce federal demands on the credit market by reducing the deficit and curbing federal credit activities. However, budget projections for the foreseeable future assume sizable deficits, which must be financed by government borrowing. The effect could be to create a constrained credit market for some time to come. If proposed decreases in federal credit to small businesses, farmers, and others are realized, how will these sectors of the economy continue to receive credit at affordable rates? Will they not be squeezed out by a combination of big business and big government borrowings? If so, does the government have a responsibility for assuring that small businesses, farmers, and others have access to reasonable credit?

Answer

Large Federal deficits will indeed constrain the credit market. This is one major reason why, as stated in the recent Budget Message of the President, "we must ensure reduction and eventual elimination of deficits over the next several years." The budget program proposed to the Congress reduces the deficit three-fifths by 1988 compared to the current services estimate, which is the deficit that would be estimated under present law without any budgetary reductions.

The proposed cuts in the budget and other credit programs will not prevent small businesses or farmers from receiving credit at affordable rates. Small business receives very little credit now from the Federal Government. In fact, less than 1% of all small business loans are directly assisted. Consequently, almost all small businesses will be helped much more by a general program of strengthening the economy and reducing the deficit than they would be helped by exempting small business loans from credit limitations.

Government programs do play a sizable role in agricultural credit. During the past decade these programs provided much more than half of all agricultural credit, primarily through the CCC, the Farmers Home Administration, and the Farm Credit system of privately owned but Government-sponsored enterprises (Banks for Cooperatives, Federal Intermediate Credit Banks, and Federal Land Banks). The proposed limitation on Federal credit will not substantially change the present Federal responsibility for agricultural credit. The Farm Credit Banks predominate among the sources of federally-assisted credit, and they will not be affected at all. The proposed decreases are largely part of the block grant proposals for the Farmers Home Administration, which are designed to improve efficiency.

User Fees

Question

What significance to the annual appropriations review process is implicit in this approach [budget reliance on user fees]? Isn't the Administration's approach of setting up user fees just another way to reduce both the deficit and annual congressional review and controls of specific programs?

Answer

The budget's heavy reliance on user fees to finance Federal programs is strictly a recognition that identifiable users (i.e., beneficiaries) of federally provided goods and services should pay the costs of those goods and services to the extent practical. The general taxpayer should not be required to subsidize the users of federally provided goods and services when the benefits accrue predominantly to those users.

Financing Federal programs through user fees is not intended to reduce, in any way, the congressional review and oversight given to these programs through the annual appropriations process. The appropriations process is as important in user financed programs as it is in general fund financed programs.

Through the annual appropriations process Congress can control the program activity in user-financed programs; just as it does general fund programs. Budget authority appropriations or annual obligation limitations provide the mechanisms to assure congressional review and control of user financed programs.

Federal-Aid Highway Obligation Limitation

Question

In the Federal Highway program, specifically, the Administration has proposed that this Committee reduce the obligation level below that set in the Gas Tax Bill. Why should the Committee undo all the hard-won progress to rebuild the nation's highways and bridges?

Answer

The Budget proposes a Federal-aid highways obligation limitation in 1983 of $11.6B, and in 1984 of $12.6B. These levels are $600M and $150M less than the obligation limitations enacted for 1983 and 1984 in the Surface Transportation Assistance Act of 1982 (i.e., the Gas Tax Bill).

The limitations proposed in the budget are a compromise between the necessity to hold down Federal expenditures and minimize the deficit, and the need to rehabilitate the nation's highways and bridges. The limitations, however, provide major growth in the highway program over the 1982 level of $8.1B (i.e., +$3.5B in 1983 and a further +$1.0B in 1984).

The proposed limitation also reflects the Administration's efforts to focus increased highway funding predominantly on the highest Federal interest programs (e.g., Interstates, primary, and bridge). The estimated obligations for State and local interest programs (e.g., secondary and urban) are basically maintained at the 1982 levels.

User Fees Mass Transit

Question

The budget request relies heavily on user fees to finance activity requiring Federal support. The Gas Tax bill also contained support for operating assistance. Local transit systems can use these funds to pay salaries or buy fuel. The Administration's budget, however, disregards Congress's firm support for transit operating subsidies and cuts funding by $600 million. Since operating funds translate directly into jobs, why is the Administration trying to undo what Congress passed just 2 months ago?

Answer

The Surface Transportation Assistance Act of 1982 does not authorize the new highway user fees to be used for transit operating assistance. In fact the Act explicitly makes these funds available for capital assistance only. As a result of the Surface Transportation Assistance Act, an additional $1.1B is estimated to be available from the mass transit

account of the Highway Trust Fund for transit funding in 1984. These funds are intended to rebuild the nation's transit system because they are suffering from age and heavy use. Congress and the Administration never agreed to make these funds available for operating subsidies.

The Administration is committed to providing transit capital assistance to local communities. Transit capital assistance has increased 31% from 1982 to 1983. The Administration's request for 1984 reflects a further increase (44% above 1982 levels).

The Administration's budget does request funding for operating assistance out of general revenues. This request ($275 million to urban areas, $18.5 million to rural) is consistent with past Administration proposals to help cities meet the cost of capital improvement and to phase out operating subsidies. The Administration supports reduced operating subsidies because Federal funding has led to marginally effective, conventional transit services where transportation needs could be better served by more cost-effective and innovative alternatives. Both the taxpayer and the transit user suffer because Federal funding creates counter-productive incentives for transit authorities. Shifting financial responsibility to local authorities should make low cost alternatives more attractive.

Budget Specifics
Treasury Enforcement Staff

Question

The Administration has placed a considerable emphasis on law enforcement with creation of the Organized Crime Task Force. This operation is patterned after the successful South Florida operation. There is no doubt that the emphasis is needed to curtail activities of organized crime. The law enforcement agencies in the Department of Treasury have been given considerable responsibility as part of the task force. This participation plus day-to-day activities requires people and resources.

- How can the administration reduce manpower, increase responsibility and expect the agencies to carry out their mission?

Answer

The Organized Crime Task Force is a special initiative of this Administration. Accordingly, the 1984 budget requests an additional 500 workyears and $32.8 million to finance Treasury's participation. This amount is allocated among Customs, BATF and IRS as follows:

Agency	($ in thousands) Budget Authority	Workyears
Customs	15,881	225
BATF	7,124	100
IRS	9,862	175

It is important to note that the reductions proposed for the Customs Service are in the commercial processing area, not in the law enforcement area. Those reductions are associated with the increased efficiency that Customs plans to accomplish in the import area.

Budget Specifics
Standard Level User Charges (SLUC)

Question

A considerable dialogue regarding space utilization by the Federal Government has been carried on over the last year. The number of government personnel is decreasing, and an outline for space utilization has, I believe, been designed, yet it appears government space is on the increase.

Hence my questions: 1) are we reducing our space requirements and 2) will this action reduce government costs.

Answer

Yes, we are reducing space requirements both in total and on a per capita basis. The GSA leasing budget is predicated on a reduction of 1.1 million square feet between 1982 and 1984. Estimated at $10 per square feet, the reduction avoids $11 million in additional space costs.

The Administration is committed to fundamental management reforms to ensure more efficient use of Federally owned and leased office and work space. These reforms, which will emphasize planning rather than case-by-case management, will reduce costs and allow the redirection of resources to essential Federal activities.

Budget Specifics
Elimination of the BATF Anti-Cigarette Smuggling Program

Question

The Administration proposes the total elimination of the Federal anti-cigarette smuggling program. This Federal effort has cost only a small fraction of the total revenues it has saved for the states and has done so in an area where individual states would be so hard pressed to do the jobs themselves. What is the justification for elimination of this program?

Answer

The Administration is of the view that this program has outlived its need and effectiveness. The program was enacted in 1978 to

reduce the extent of revenue losses suffered by States through cigarette smuggling. Indeed, between 1978 and 1981 state cigarette revenues have increased by $241 million or 6.6%

While the Act was targetted against interstate "over the road" smuggling that states had limited ability to handle, current assessment indicates that diversion at the stamping agent level is the major source of state revenue loss. BATF admits that it has difficulty investigating such cases in large part because the law precludes open inspection of records, administrative inspection warrants or search warrants. Moreover, these are complex tax cases that are not cost-effective in terms of returning significant revenues to states.

Finally, we suggest that the absence of BATF agents in this area is unlikely to hurt states since states have expanded their enforcement expertise in this area and the BATF level has typically been low - operating at a program level of 56 agents.

Budget Specifics
Elimination of BATF International Trade Program

Question

The Bureau of Alcohol, Tobacco and Firearms is the leader of the U.S. team seeking to open foreign markets to U.S. wines, and has had dramatic successes at minimal cost to the government. Yet the Administration has eliminated BATF's entire international trade request for FY 84 of less than a million dollars. Are you really saving money that way in the long term?

Answer

The 1984 budget proposal does not suggest that U.S. wines should not be promoted in foreign markets. Rather we question the need to maintain a separate Federal program for this commodity. The promotion activity could be conducted by the industry or by other Federal agencies whose main mission is trade promotion and policy.

NONDEPARTMENTAL WITNESSES

TOWNSEND-GREENSPAN, INC.

STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN, INC.

Senator STEVENS. Now we are going to turn to the testimony of Dr. Alan Greenspan and Dr. George Perry.

Is Dr. Perry here?

It is our intention to proceed with the statements before we proceed to questions.

Dr. Greenspan is the former chairman, as we all know, of the Council of Economic Advisers, president of Townsend-Greenspan, Inc., and most recently has distinguished himself as the chairman of the bipartisan Social Security Commission.

Will you proceed, Doctor? We are happy to have you take the time to come and give us your opinions as to the economic situation that confronts our country.

Mr. GREENSPAN. Thank you very much, Mr. Chairman.

I would like to read excerpts from my prepared statement and hopefully put additional materials in the record.

ECONOMIC RECOVERY SEEN

There can be no doubt that the economy has turned. All of the classic symptoms of the normal cyclical recovery are in place.

The question is not whether the recovery is under way, but rather how long will it last? It is clear in retrospect that the recession bottomed sometime in December. As a rather subnormal inventory liquidation seemed to come to an end early last summer, it suggested a rather technical recovery for the first half of 1983. However, the recession regripped the economy and the final inventory exhaustion took place, reaching its peak late in the year.

The severity of the final phase of the downside of the inventory cycle now implies a rather vigorous initial stage to the recovery.

INCREASE IN METAL PRICES

The first sign that the recession had bottomed was signaled by a sharp increase in steel scrap prices for early January delivery.

Copper and other nonferrous metal prices had already started to edge higher but when the worst performer, ferrous scrap, joined the group it was a clear signal that in the industries where inventory liquidation had been deepest—that is, the basic durable materials producers—liquidation had run its course.

RECOVERY IN PRODUCTION AND NEW ORDERS

In recent weeks the rate of liquidation has slowed dramatically and production has begun to move up toward the consumption level. Backlogs still falling, although at a reduced rate through December implied that new orders were continuing under the production level and, of course, far below the levels of consumption.

We are now seeing a fairly dramatic recovery in both production and new orders. The latter is likely to pose some sharp increases in the weeks immediately ahead.

In short the last 2 months have impressively fit into the pattern of the classic textbook description of the business cycle's lower turning point.

Indeed, the near momentum of the turn should carry the economy at a reasonable brisk pace through midyear. There are very significant differences in this economic turn, however, which suggests that following the typical post-World War II business cycle, recovery is going to be difficult.

HIGH INTEREST RATES

The first and most important problem is that interest rates, most particularly long-term rates, remain too high and threaten to stay too high to support a normal recovery in housing and capital goods.

Recovery in these sectors is essential to restoration of relatively full employment. The huge projected Federal deficit in the years 1985 and beyond are creating a fear in the world financial community of a reignition of inflationary forces. The decline in the rate of inflation last year was real and credible. The markets, however, clearly assumed that the financing pressures from the deficit will require a massive accommodation by the Federal Reserve.

INCREASE IN MONEY SUPPLY GROWTH

A sharp increase in money supply growth is presumed to reignite inflationary pressures not necessarily this year or next, but on an average over the next 10 to 20 years.

The inflation premium embodied in long-term interest rates is, of course, the average expected inflation rate over the full maturity of the debt instrument to which it applies.

The relationship between money and inflation may be askew in the short run but over the long run the evidence is conclusive that the rate of inflation is tied to the rate of money growth, and to income velocity has exhibited a remarkably stable long-term trend.

This is another way of saying that over the long run the level of prices must be proportional to unit money supply; that is, the level of money divided by the level of production.

A necessary condition for a restoration of high employment is a reduction in the inflation premiums embodied in long-term interest rates. This would bring down the levels of rates. That in turn will require an easing of the fear that our fiscal processes are in a state of long-term hemorrhage. While a sharp decline in the long-term deficit outlook is not required as a condition of full recovery, a clear indication that the trend is down is probably mandatory.

BUSINESS BALANCE SHEETS

A second factor inhibiting a full recovery is the state of business balance sheets. For the last couple of decades business has tended to finance a disproportionately large amount of its capital investment with short-term debt.

As a consequence, the ratio of short-term debt to total liabilities has risen to a point where corporate financial officers are becoming seriously concerned about the potential stability of their companies. In recent years they have been jolted by the impact of sharply rising short-term interest rates on balance sheets overweighted with short-term debt. They are currently looking for ways to fund a large part of the short-term debt through longer-term issues.

Moreover, the decline in capital asset ratios is pressing corporate financial officers to increase the proportion of equity capital on their balance sheets.

When there is concern over the structure of a company's balance sheet, the focus of the corporation tends to move away from long-term capital investment and long-term market expansion toward endeavors to fend off the possibility of severe liquidity or at worst chapter 11. In fact, some of these severe balance sheet financial pressures in recent years have been a factor in inducing an inordinate amount of long-term borrowing, a major factor keeping real short-term interest rates at their current high levels.

INTERNATIONAL FINANCIAL SYSTEM

Finally, the third major threat to the restoration of the normal recovery is the strained international financial system. The obverse of the tremendous increase in corporate borrowing on a worldwide basis if the dramatic expansion in the loan portfolios of the banks engaged in significant lending across national boundaries.

Until fairly recently, the cause of the tremendous inflation-induced expansion and assets capital asset ratios declined. Going to the onset of exchange rates and volatile interest rates, the fluctuation between the market and book value of assets have increased very dramatically. This means that both potential capital gains and losses have been significantly higher than through most of the post-World War II period.

In short, there is a higher risk of loss now than, say, 10 or 20 years ago.

This should lead one to expect that book capital, as a ratio to book assets should be higher to absorb larger potential losses. That, of course, is what bank capital is for. In fact, of course, capital is lower although there are indications recently that many international banks are moving to regress this deficiency.

Bank capital inadequacy is being exaggerated by the major problems with loans to the developing nations and to the Eastern bloc countries.

As a consequence, the capacity for international lending has been dramatically reduced over the past several months. Demand for international credits is also declining as oil prices ease and current account surpluses and their obverse deficits are both declining.

The danger, however, is that the constriction will also reduce the aggregate movement of nonoil goods and services across national borders.

TRADE PROTECTIONISM

The protection system is only one of the major factors which could reduce the necessary flow of international trade. Should trade decline, the United States, which has become increasingly more dependent upon it in recent years, would have difficulty restoring its factory operating rates to more profitable levels.

In summary, therefore, while the recovery is underway, and impressive in scope, there are three major and partly interrelated roadblocks that will have to be cleared away before the American economy can return to a fully prosperous state.

The major one, by far, is the removal of inflation premiums from long-term interest rates. If a significant lowering of long-term budget deficit expectations occurs and long-term interest rates fall, short-term rates will decline. This will ease the problem of domestic balance sheets and the pressure on international lending, as well.

Thank you.

THE BROOKINGS INSTITUTION

STATEMENT OF DR. GEORGE L. PERRY, SENIOR FELLOW, THE BROOKINGS INSTITUTION

PREPARED STATEMENT

Senator RUDMAN [presiding]. Thank you, Dr. Greenspan.

Dr. Perry, we would like to proceed with your statement. Your full statement if you have it will be incorporated in the record and then we will go to questions.

Mr. PERRY. Thank you, Senator.

I will summarize the written statement that I gave you in order to be brief.

[The statement follows:]

PREPARED STATEMENT OF GEORGE L. PERRY*

SENIOR FELLOW

BROOKINGS INSTITUTION

February 22, 1983

Two years ago, the Administration proposed and Congress accepted a series of tax changes and spending plans that led to an unintended revolution in budgetary policy. That it is a revolution is evident from the unprecedented peacetime budget deficits that are now in prospect for future years even on the assumption that the economy is operating at high levels of employment. That this revolution was unintended is clear from a comparison of budgetary prospects today with those projected two years ago when current policies were put in place. This year's budget document offers an extensive discussion of why things turned out as they did. In part the answer lies in the vague and false promises that were offered in the name of supply-side economics. But whatever the reasons, what matters now is what is done about it.

Structural and Cyclical Deficits

As a start to assessing what needs to be done, the distinction between the structural and cyclical components of the actual deficit is important and has been featured by both the Office of Management and Budget and the Congressional Budget Office in their analyses of the budget. The cyclical component represents the revenues lost and the expenditures automatically induced as a result of the economy operating below high employment levels. The structural component represents the

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balance in the budget that would exist if the economy were in fact operating at high employment levels.

It is the structural deficit that measures the impact of fiscal policy on the economy. However cyclical deficits are not entirely benign because they lead to larger interest costs for debt service in future years thus enlarging future structural deficits. Low interest rates and maintained prosperity are the formula for holding down interest costs. Thus far in the 1980s, their opposite has enlarged the structural deficit by over $20 billion.

Both the level and the change in the structural deficit are important to economic performance but in somewhat different ways. The level helps to determine the composition of total output by affecting the real interest rate, which is also importantly influenced by monetary policy. In particular, when total GNP is constrained, either by monetary policy or by limited real resources, a large structural deficit will lead to high real interest rates and relatively low demand from interest-sensitive sectors such as business investment, automobiles and housing, and also to a high exchange rate for the dollar and thus a high level of imports relative to exports. Conversely, a fiscal policy designed to maximize the share of GNP going to investment would provide for a surplus in the structural budget so as to keep real interest rates down.

Large structural deficits can, in principle, raise long-term interest rates well before high employment is achieved by influencing expectations about future short-term interest rates. Historically, the structural deficit in the United States has been near balance whenever peacetime prosperity was achieved. The prospect of historically unprecedented peacetime deficits later in this decade appears to be holding up long-term interest rates today.

Changes in the structural deficit have a different effect on economic performance. When the structural deficit expands it adds to total demand for a time and when it contracts it reduces demand. The structural deficit has been temporarily enlarged to help the economy

out of recession on several occasions.

Today's Challenge

The Congress now faces the challenge of providing a budgetary policy that addresses two quite different problems over two different time horizons: First, the budget should respond to the hardships of recession and unemployment today and should aid in recovery from that recession. This calls for an expansion in the structural deficit at present. Second, the longer-run structural deficit should be substantially reduced so that government demands do not crowd out interest-sensitive private demands when prosperity is restored to the economy and so that today's long term interest rates are not kept high by financial market fears of high interest rates in the future.

These propositions are quantified in table 1. It shows present estimates of baseline budgets through fiscal year 1988 and the changes to the structural deficits in those baseline budgets that I believe are appropriate based on the reasoning I have just outlined. I relied on the baseline estimates of the Congressional Budget Office in preparing this table. One would draw much the same general conclusions about needed budgetary changes from the Administration's estimates except for differences in projected defense spending which I discuss later.

I should add that a table of this sort does not imply that we can project structural deficits with great precision or that anyone can prescribe the structural deficits that are appropriate for the economy without qualification. Not only is our ability to make these estimates less than perfect, but the economy can survive with a range of structural deficits, as I suggested above. However we are trying to do more than just survive. It would be a far worse mistake to conduct budgetary policy without such an analysis than it would be to treat it as gospel.

Table 1. Projected Deficits (-) and their Structural and Cyclical Components
(percent of GNP)

	Fiscal years						
	1982	1983	1984	1985	1986	1987	1988
Actual deficit, CBO baseline	-3.6	-6.1	-5.6	-5.6	-5.6	-5.6	-5.6
Cyclical deficit, implied CBO	-2.9	-4.2	-3.2	-2.5	-2.9	-1.6	-1.3
Structural deficit, CBO baseline	-0.7	-1.9	-2.4	-3.1	-3.6	-4.0	-4.3
Proposed reductions in structural deficit	...	...	...	1.0	2.0	3.0	3.5
Proposed structural deficit	-0.7	-1.9	-2.4	-2.1	-1.6	-1.0	-0.8
Addendum:							
Proposed deficit reductions in $ billions	...	...	...	41	88	140	175
Proposed structural deficits in $ billions	-23	-69	-91	-87	-71	-47	-40

First three rows based on Congressional Budget Office estimates in Table 11 of The Outlook for Economic Recovery, Feb. 1983.

Aiding Recovery

For fiscal 1983 and 1984, the average baseline structural deficit rises by 1.5 percent of GNP from its 1982 level. Such a fiscal change at this stage of the cycle has ample precedent and it will aid recovery from the deep and prolonged recession that is now ending.

In offering this judgment, I obviously disagree with those monetarists who have taken the experience of the last few years, when fiscal policy has not been restrictive and the economy has nonetheless been pulled into a deep and prolonged recession, as evidence that only monetary policy matters for economic stabilization. This is a misreading of what has happened. There used to be a debate about

whether monetary policy was impotent to produce an economic recovery because "you cannot push on a string". But nobody ever doubted that you could pull on a string. In the past few years, monetary policy has been pulling down very hard on the economy and has overwhelmed fiscal policy in the process.

Today, the main force ending the recession is the unleashing of pent up demand that has been long constrained by high interest rates in sectors such as housing and autos. But an expansionary fiscal policy is also an important ingredient in a forecast for a good recovery. Rising interest rates could enfeeble or abort a recovery, even if fiscal policy was supporting it. But that would represent a conflict of goals between monetary and fiscal policy. I do not anticipate it and certainly would not prescribe it. The economy as a whole is very depressed and we should not fear a normal-speed recovery at this stage of the cycle -- not if we are serious about reducing unemployment here and throughout the world.

I conclude that the overall thrust of near-term budgetary policy is about right, and have shown no "proposed reductions" for fiscal years 1983 and 1984 in table 1. If anything, the Congress should not shy from enlarging temporary programs aimed at alleviating the hardships of recession right now; and there is room to start cutting back a bit on the structural deficit for fiscal 1984, which is now scheduled to grow still further. Such action on the fiscal 1984 structural deficit is not imperative. But it would be appropriate and might be necessary as a start toward reducing structural deficits in later years since many actions that would affect the out-year deficits would have to be initiated with the fiscal 1984 budget. Defense weapons systems and the third-stage of the 1981 tax cut are two important examples.

The Longer Run

As we move from the immediate short-run problems of the economy to the longer run, the need to reduce structural deficits becomes

important. Unless we want to invite high real interest rates and their effects on the composition of output, the average structural deficit of 4 percent of GNP shown as the CBO baseline for fiscal years 1986-1988 in table 1 is far too high by any historical or analytic standards. The proposed change in the baseline budget would gradually reduce the structural deficit to below 1 percent of GNP by fiscal 1988. One could construct a case for a slightly different time path or end point. But given the baseline that we start from, the proposed path of structural deficits is reasonable and, with some unpleasant choices, achievable.

During 1975-79, the last period of expansion from a deep recession, budget policy shifted more sharply toward surplus once recovery was well underway. Policy aided recovery from the deep recession by enlarging the structural deficit by 1.9 percent of GNP in 1975, partly through a temporary tax reduction. It then shifted toward surplus over the next four years and was actually in surplus by 0.2 percent of GNP by 1979 -- a swing of 1.7 percentage points over the four year period.

The proposed swing toward surplus this time is only about 1 percentage point. But achieving it will require more active policy changes. Instead of the temporary tax reduction that automatically went away after 1975, the baseline projection includes revenue losses after 1983 from the third stage of the 1981 tax cut, and growing revenue losses from the liberalization of depreciation rules. Inflation raised revenues as a share of GNP between 1975 and 1979 while the scheduled start of indexing in 1985 keeps the ratio from rising this time. Finally the share of defense purchases declined slightly during 1975-79 and is scheduled to rise sharply this time.

Alternatives for Reducing Future Structural Deficits

Hard choices must be made about reducing baseline expenditures and raising revenues. Economics can provide only limited guidance on these choices which will and should involve considerations of equity and

national priority. I would just like to present some facts and to dispel some notions that have been widely expressed in recent years and that have been used to limit the range of options that the Congress might consider.

Nobody likes to pay taxes. But we are not an overtaxed society. Table 2 compares revenues collected at all levels of government in the United States with government revenues in other major industrial countries. Only Japan ranks lower than the United States and its revenue share jumped sharply during the decade of the 1970s. If the revenue needed to support defence spending were subtracted, even Japan would rank below the United States. Over various periods, we have admired the economic performance in some of these countries and deplored the performance in others. But there is no connection between

Table 2. Current Receipts of Government as Percentage of GDP, Various Countries

	1960	1970	1980	Change 1970-1980
United States	27.4	30.3	32.7[a]	+2.4
Canada	26.0	35.2	37.1	+1.9
Japan	20.7	20.7	28.2	+7.5
France	34.9	39.0	45.4	+6.4
Germany	34.8	37.5	42.8	+5.3
Italy	28.8	30.4	37.5	+7.1
United Kingdom	30.3	40.7	40.4	-0.3
Sweden	32.2	46.9	57.1	+10.2

Source: OECD

a. Data for 1982 are similar to 1980 for the United States and unavailable for other countries shown.

that performance and the tax burdens shown in table 2, either across countries or through time.

The moral is that, in the neighborhood of the experience of industrial countries, there is no level of taxation that we should seek to emulate because economic performance demonstrates it is optimal. Economies can and do function both well and poorly with a wide range of tax burdens. If the structural deficit is to be closed in future years, there is no reason in terms of economic performance to avoid doing much of the job by increasing total revenues.

The choice between raising revenues and cutting outlays depends simply on what we find worth paying for. The Administration's argument that nondefense spending has risen to unacceptable levels is a value judgment not an economic truth. Even a very broad look at what has happened in various spending categories suggests there is no broad agreement with that value judgment and little or no room for reducing out-year structural deficits through further cuts in nondefense spending.

Between 1965, often looked back on as a golden age, and 1988, spending on social security and medical care each rise by about 2.5 percent of GNP. These increases are widely supported and almost entirely financed by payroll tax increases that are broadly understood by the public as a way of paying for these programs. The social security commission has just made its proposals, which will cut baseline spending slightly, and we may choose to make others in the future. But the increases that have occurred are hardly an indictment of the nondefense budget. They are an expression of what our society has wanted and been willing to pay for. Nobody wanted the increase of 1.5 percent of GNP devoted to interest costs that occurs between 1965 and 1988. These outlays are only controllable by reducing budget deficits and interest rates.

These three budget categories -- social security, medical care and interest payments on the debt -- account for essentially all of the

increase in nondefense outlays between 1965 and 1988. All other nondefense spending, including means-tested programs and general revenue sharing which simply reduces tax burdens at other levels of government, had risen noticeably by 1980. By 1988 spending on all these other nondefense programs is projected back at 1965 levels in the baseline budget. I find it hard to believe that, on balance, still further cuts are going to be made in these programs and rather easy to believe the Congress will want to spend somewhat more.

Defense spending rises well above 1965 levels in the CBO baseline (and further above it in the Administration's baseline estimates). This is where discretion to spend more or less is greatest. I have no expert opinion on defense spending. But I would make the obvious point that we should be willing to pay for the level of defense spending we need. Inevitably, the main choices in reducing the structural deficit will be between cutting defense spending and raising revenues. If we had faced that choice squarely two years ago, we would not have such a budgetary problem today.

This year's budget both directly and implicitly invites raising revenues as a way to reduce structural deficits. First, in discussing how the structural deficit got so large, the Budget document disassociates the Administration from tax indexing and other special features of the 1981 tax act. In view of this, eliminating tax indexing should be a relatively uncontroversial way to raise needed revenues. Second, the Budget calls for a contingent tax increase raising $46 billion in fiscal 1986. A contingent tax increase will appear gimmicky and will not be fully believed by the financial community whose apprehensions about future deficits may be helping to keep up long-term interest rates. Since the Administration fully expects the contingencies to be met, they should welcome an outright tax increase of comparable size.

Table 3 shows the reductions from baseline expenditures that would still be needed to achieve the proposed path for the structural deficit

if indexing were eliminated, permanent tax increases were made that raised as much revenue as the Administration's proposed contingency tax does in 1986, and the bi-partisan proposal on social security was accepted by the Congress.

Starting from the CBO baseline projections, the needed reductions in outlays range from $26 billion in fiscal 1984 to $54 billion in fiscal 1988. If the Administration's baseline budget is taken as a starting point, the reductions would need to be even larger as the last

Table 3. Ways and Means to Proposed Deficit Reduction (billions of dollars)

	Fiscal years			
	1985	1986	1987	1988
Proposed deficit reduction (+)	$41	$88	$140	$175
Reduction available from:				
Bi-partisan social security proposal	9	12	14	27
Cancelling tax indexing	6	17	28	40
Tax increase equivalent to proposed contingency tax	...	46	50	54
Remainder for expenditure reduction	26	13	48	54
Remainder with OMB rather than CBO defense baseline projections	41	35	79	91

line of table 3 shows. The CBO baseline for defense spending is well below the Administration's, with the difference growing to $37 billion by fiscal 1988. From the Administration's defense baseline, the needed cuts range from $41 billion in fiscal 1984 to $91 billion in fiscal 1988.

If the Congress chooses not to cut outlays by these amounts, the structural deficit targets could be met with larger tax increases than those suggested in table 3. Cancelling the third-stage of the 1981 tax

cut, which is scheduled to take effect at mid-year, would be one way of providing more revenue. But doing so would reduce the near-term fiscal stimulus from the budget that is helping the economy out of recession. This conflict between immediate and longer-run fiscal needs would have to be weighed. I believe the forces for expansion are strong enough that the recovery would not abort without the tax cut. And it could be quite vigorous if the Federal Reserve pushed short term interest rates down further to make up for cancelling the tax cut.

Among other ways of raising substantial amounts of new revenue, my own choice, and I believe that of most economists, is also politically the most difficult: broadening the income tax base by eliminating many of the special tax provisions that now exempt so much income from taxation. Such base-broadening, if sweeping enough, could raise all the revenue needed and at the same time reduce marginal tax rates. Specific proposals along these lines, such as that of Senator Bradley and Congressman Gephart, already exist.

On closing, I should reiterate what I said earlier -- that projections of how much structural deficits need to be reduced will inevitably appear more precise than they are. But no sensible view of the future will make the budgetary problem that confronts the Congress go away. And the budgetary changes that are desirable could as easily be larger as smaller than those I have suggested.

Faced with the need to reduce out-year deficits, with inevitable uncertainty about just how big those reductions need to be, and with markets that feed on expectations of how big the deficits will be, my advice is to get started decisively but not to tackle the whole apparent 1988 problem yet. Doing what needs to be done for fiscal 1986 is a prudent middle course.

QUESTION ON SPEED OF ECONOMIC RECOVERY

Mr. PERRY. I agree recovery is under way. We can have a good recovery. I am less concerned than the administration has been about the need to make this recovery exceptionally slow. Indeed I think we need a good recovery and not an exceptionally slow one if we are to deal with a number of our problems.

I have addressed most of my remarks in this testimony to the budget problem that we have and the ways in which we might deal with it.

STRUCTURAL AND CYCLICAL COMPONENTS OF DEFICIT

In starting to assess what needs to be done, the distinction that both the Office of Management and Budget and the Congressional Budget Office have made between the structural and cyclical components of the deficit is important, and one that we should focus on.

It is the structural component that represents the balance in the budget that would exist if the economy were in fact operating at high employment levels. It is this structural deficit that represents the impact of fiscal policy on the economy. The actual deficit, which includes a large cyclical component, is not entirely benign. Indeed fiscal deficits of the size that we have added to the structural deficit by adding to the debt on which we must pay interest and they have contributed to the size of the structural deficit to date.

But the only cure for the cyclical component is to get interest rates down and to get the economy prosperous again.

Today's challenge is to provide a budgetary policy that addresses two very different problems over two different time horizons. First and today, the budget should respond to the hardships of the recession and unemployment that exist and should aid recovery from that recession. This calls for an expansion of the structural deficit at the present time. This is what the budgetary policy now in place actually provides.

REDUCTION OF STRUCTURAL DEFICIT

Second, the longer run structural deficit must be substantially reduced so that Government demands don't crowd out interest-sensitive private demands when prosperity is restored to the economy and so that today's long-term interest rates aren't kept high by fears in the financial markets. These propositions are quantified in table 1 of the testimony which shows the baseline deficits, their cyclical component, and the structural deficit. It also shows the reductions I propose are needed in the structural deficit. These reductions define the size of the problem before the Congress.

In the immediate future, fiscal 1983 and 1984, I would propose no changes in the structural deficit. The structural deficit grows in that period and that is appropriate as an aid to getting the economy out of the recession.

However as we go beyond that in time, the structural deficits continue to grow. We should be reversing that trend and causing the structural deficits to decline. The particular path for the decline in those deficits that I have outlined in table 1 is somewhat judgmental. I don't

think we can pretend to do these things so accurately that we can set targets for several years from now and be terribly precise about them. But the targets that I lay out here are modest and we should probably not settle for doing much less.

They call for reducing the structural deficit by about 2 percent of GNP in 1986, and by about 3½ percent of GNP by 1988. To try to deal with the 1988 problem at this distance implies more precision in our ability to do these things than we have. But I think the fiscal 1986 problem is close enough that we have some confidence in what needs to be done and what I have suggested is probably the minimum that needs to be done at that distance.

OUTYEAR DEFICIT REDUCTIONS

To accomplish outyear deficit reductions of the size suggested here is going to require some hard choices about either reducing baseline expenditures that are being projected or raising new revenues. Economics can provide only limited guidance on these choices which will and should involve considerations of equity and national priority and national needs. I would just like to present a few facts and dispell some notions that have been widely expressed in recent years and that have been used to limit the range of options that the Congress might consider.

TAXATION

Nobody likes to pay taxes. But we are not an overtaxed society. Table 1 in the testimony compares the United States in that respect with all the other major industrial nations of the world. There is no way that one can look at that record and conclude that economic performance has been related to a particularly small or a particularly large proportion of revenues going into GNP. There are countries on that list whose performance we have admired at various times and countries on that list that have had poor performance, countries that have had good and bad productivity, good and bad inflation. There is simply no connection between the performance that we desire for our own economy and what was happening to revenues as a share of GNP in those countries.

So our decisions in that respect are going to be decisions about what kind of society we want, what we think is important. They should not be decisions based on the mistaken idea that economics teaches there is an appropriate level for the size of revenues in the economy. In the neighborhood of recent experience of the industrial countries, we are on the low side in all respects and we should not be afraid of dealing with the structural budget deficit by raising revenues if that is the only choice available to us.

In fact the choice between raising revenues and cutting outlays depends simply on what we find worth paying for. The argument the administration has made that nondefense spending has risen to unacceptable levels is a value judgment and not an economic truth. I think even a broad look at what is happening in various spending categories suggests that there is no broad agreement with that value

judgment and that there is in fact little room for reducing outyear deficits through further cuts in the nondefense areas.

To look at the history of what happened in the budget, I start in 1965 which some people think of as a golden age, and go through 1988. Three budget categories account for essentially all the increase in nondefense outlays over this period. These are social security, medical care, and interest payments on the debt.

SOCIAL SECURITY INCREASES

Social security is an issue which has been dealt with at length by Allen Greenspan's commission. It is an issue on which the public has spoken. Increases in social security are something the public understands they have to pay for. I don't think increases in that area reflect an undesired increase in nondefense spending.

MEDICAL CARE

Medical care is quite a different problem. It is going to pose serious questions that the Congress is going to have to deal with because the cost per unit of medical care is rising so rapidly. How that gets paid for, whether older people pay for medical care, out of their own pocket or whether the Government continues to shoulder that burden, is a secondary decision compared to the decision of what to do about the total cost of medical care.

INTEREST PAYMENTS ON DEBT

Interest payments on the debt, the third item that has risen so much, is something nobody wants. As I suggested the only answer to that is lower interest rates and a prosperous economy which will reduce actual deficits.

Defense spending rises well above 1965 levels in the baseline estimates and even further above it in the administration estimates. I am not an expert in the defense area. I have no expert opinion to offer. I would only make the obvious point that we should be willing to pay for the level of defense spending that we need. And we should look at what we need as carefully as we look at other areas of the budget.

Inevitably, I think the main choices in reducing the structural deficit will be between cutting defense spending and raising revenues. Realistically those are the options that we face. If we had faced those choices squarely 2 years ago, we wouldn't have the budget problem that we have today.

Table 3 summarizes some of these numerical propositions by showing what spending reductions remain if we make certain tax increases that in a way are suggested by the administration's own budget.

In table 3 I start with the proposed deficit reduction that is needed, which in fiscal 1986 is $88 billion. The reduction is $12 billion if the bipartisan social security proposal is accepted, $17 billion is reduced if tax indexing is canceled or delayed for 5 or 6 years, $46 billion is reduced if the tax increase the administration proposes as a contingency tax is in fact accepted as permanent. That leaves a remainder for ex-

penditure reduction of $13 billion, accepting the CBO estimate, or $35 billion accepting the administration estimate of the defense baseline.

The needed reductions grow in future fiscal years but steps that were taken to meet a 1986 target of this sort would also provide increased savings in the outyear budget if they include defense systems or, to a lesser extent, tax increases whose value also would grow in the future.

If the Congress doesn't want to cut outlays by these amounts, then the budget deficit targets could be met with larger tax increases than those suggested in table 3.

CANCELLATION OF THIRD-STAGE TAX CUT

Canceling the third stage of the 1981 tax cut, which is scheduled to take effect at midyear, would be one way of providing more revenue. But doing so would reduce the near-term fiscal stimulus from the budget that is helping the economy out of recession.

This conflict between immediate and longer-run fiscal needs would have to be weighed. I believe the forces for expansion are strong enough that the recovery would not abort without the tax cut. And it could be quite vigorous if the Federal Reserve pushed short-term interest rates down further to make up for canceling the tax cut.

ELIMINATION OF SPECIAL TAX PROVISION EXEMPTIONS

Among other ways of raising substantial amounts of new revenue, my own choice, and I believe that of most economists, is politically the most difficult: Broadening the income tax base by eliminating many of the special tax provisions that now exempt so much income from taxation.

Such base-broadening, if sweeping enough, could raise all the revenue needed and at the same time reduce marginal tax rates.

Specific proposals along these lines, such as that of Senator Bradley and Congressman Gephart, already exist.

On closing, I should reiterate what I said earlier—that projections of how much structural deficits need to be reduced will inevitably appear more precise than they are. But no sensible view of the future will make the budgetary problem that confronts the Congress go away. And the budgetary changes that are desirable could as easily be larger as smaller than those I have suggested.

Faced with the need to reduce outyear deficits, with inevitable uncertainty about just how big those reductions need to be, and with markets that feed on expectations of how big the deficits will be, my advice is to get started decisively but not to tackle the whole apparent 1988 problem yet. Doing what needs to be done for fiscal 1986 is a prudent middle course.

Senator RUDMAN. Thank you, very much, Dr. Perry.

We will now turn to questions from the committee.

I would start out with a brief question for each.

ENTITLEMENT PROGRAMS

First, Dr. Perry, I guess from looking at your testimony and the other testimony that we have heard, that in terms of what we have to do in terms of reducing the outyear structural deficit, there was a broad agreement as to what the percentages ought to be.

I take it you do not consider it a viable alternative to take a look at the entitlement programs as the administration suggested and you are simply saying that the reform will have to come in two areas, defense spending and increased revenue.

Is that an accurate summary?

Mr. PERRY. We are talking about big dollars. And those areas are the only places to find big dollars, realistically.

Senator RUDMAN. You do not think major change in the entitlement programs through statutory reform is a viable alternative?

Mr. PERRY. When I looked at those—if we leave out something like social security which is being decided on its own, which in any case carries with it its own financing—if we are looking at other programs which would be financed out of a larger deficit, there doesn't seem to be enough money there.

One can make changes if that is what the people want, and some savings will surely come from these areas. But, again, I don't think that there are a lot of dollars there compared to the size of the problem.

Senator RUDMAN. Dr. Greenspan, just a brief question to you.

First, I don't know if you have had a chance to look at the table that Dr. Perry has presented to us this morning concerning relative tax policy of various nations. He rather strongly indicates in his statement that you cannot draw too much relationship between economic health and percentage of GNP that goes into revenues at all levels of government. Is that something you agree with?

Mr. GREENSPAN. I think we need to look at a cross regional, cross country international comparison, because it is fairly obvious that different countries behave in different ways.

We have to be terribly careful about understanding how each individual country and each individual budget system functions.

What concerns me particularly about the United States is that we have built into our system and have had built into our system for a number of years a rate of growth in outlays which has been exceeding the rate of growth in the tax base and that essentially what we are looking at is the continuous upward drift in tax rates.

Do I think that if tax burdens were somewhat higher, the economy would come to a roaring halt? No; I don't. There is a point, however, where you do get to something which has got to have an effect. What concerns me is that our fiscal processes at this stage are fundamentally so disarrayed in my judgment that we don't have the luxury of saying, let's fine tune our tax structure to a slightly higher percentage GNP because we will resolve it in 1987 or 1989 or something like that.

I don't believe that. Unless we endeavor to stem the rise and proportion of revenues to GNP now, by now I mean in this part of the decade, I think we are going to find ourselves continuously moving into

a position where we will finally decide that our tax burden has indeed had a major impact on our growth and at that point there is very little we can do about it.

VELOCITY GROWTH

Senator RUDMAN. Finally, there is a lot written lately and you commented in your statement about the so-called velocity growth. There are those in the Congress who have been saying for the last year that the Fed's policy was too restrictive, that they had helped cause this problem we had in the last year, that we are now on the verge of recovery. In fact you believe one is taking place as do most of your colleagues. Yet there is still considerable criticism of the Fed.

Now there is new criticism, that the Fed's policy at this time could cause a serious problem because of the velocity.

Could you comment a bit more on that? Dr. Perry, I would like you to comment also.

Mr. GREENSPAN. As you know, the velocity levels have fallen well below what most people expected. If one just takes the arithmetic as is, one presumably has the numerical capacity of significant increases relative to GNP, of money supply growth. So one could in a sense, if you took those numbers, literally maintain a fairly restrictive growth in the various monetary aggregates.

I don't think, however, that we should be overly impressed with these short-term fluctuations in velocity. It strikes me that every time there is a critical turn in the economy, something happens to velocity which creates a problem for analysis. I remember this happened in 1975. It has happened on several different occasions.

I would be disinclined to look terribly closely at short-term moves in velocity. I would, however, be very careful to make certain to recognize that over the long run money really matters and that money may well be the most fundamental factor in inflation. I don't consider inflation really an inconvenience of numbers.

I consider it a destroyer of jobs, a destroyer of growth and ultimately a destroyer of the economy. In other words, a lot of people talk as though inflation is bad, let's get rid of it, as though there is something abstractly evil about the fact that price levels are going up.

I couldn't care less. The question is, does it destroy the physical structure of the system? Consequently, we have to be terribly careful with long-term monetary policies.

My own view is that the Fed at this particular stage is in a box. It is in a box basically because I don't believe as Dr. Perry does that it has the capacity to significantly lower short-term interest rates at this time without creating some upward drift in the long-term rates as a consequence of increased fears of a reignition of inflationary forces.

While certainly other things equal the lower short-term rate structure is better, my own impression is at the moment it is long-term rates that are far more important to the sustaining of recovery than the short-term rates.

The Fed has been endeavoring to push short-term rates down while concurrently trying to audit what is going on in the bond market.

So long as there is a downward drift of long-term rates they can move the rate structure without adverse long-term inflationary consequences. However I think as you well know, since November, long-term rates have, if anything, drifted upward. I don't think it is caused by the diversity of the Federal Reserve governors or the open market committee chairman.

They have a terribly difficult policy problem which in my judgment is not resolved from the monetary side but from the fiscal side.

MONETARY POLICY DISCUSSION WITH INFLATIONARY FACTORS

Mr. PERRY. I am as concerned about inflation as Allen is. But some of the suggestions for monetary policy made in connection with inflation, I think, could cause problems that are even more pressing and more severe.

There is no evidence that the Federal Reserve cannot today reduce short-term interest rates. And there is no evidence that, if the Fed were to try to reduce short-term interest rates, it would have perverse effects on long-term rates.

I have heard that many times. I find no evidence that it is true. I find evidence indeed to the contrary. So I believe if our aim is to reduce interest rates today, we can do it and we can do it both in the short end and the long end of the market.

The question of inflation is a terribly important one. But we shouldn't be mystical about it. Inflation and the fear of inflation is not going to be reignited if the Federal Reserve provides liquidity that the world needs today. And the high level of real short-term interest rates today is consistent with the view that the world is short of liquidity.

This is causing enormous problems, and some vague fear of longer-run inflation—which I think is always a legitimate concern but not a present danger—should not cause us to disregard these real problems that are with us today.

The real problems are all around us. They include the world debt situation and all the problems of an economy flat on its back. If it were true that the only way we could deal with those problems was by reigniting inflation and causing ourselves deep problems in the future, we would be in a box. But that is not the case.

There is a hardcore problem. The hardcore problem is that we have not found a way to run this economy at high employment levels and at the same time assure ourselves that we don't have inflation. That is a problem that has not been resolved by the policy mix of the last few years.

It may be that ultimately we are going to have to deal with that problem more directly. But that is not the subject of this discussion. For now, we can have a good expansion without reigniting inflation. The real choice is whether we want that expansion, not whether we should want it only if the Federal Reserve behaves in a particular way.

Senator RUDMAN. Thank you very much.

Senator Stennis?

SOCIAL SECURITY RECOMMENDATIONS

Senator STENNIS. Mr. Greenspan, I am more or less out of order I judge at this sitting to ask you much about conclusions in the work with reference to the social security recommendations you made. I do want to commend you for your work and leadership in that role.

Mr. GREENSPAN. Thank you, Senator.

Senator STENNIS. This matter has vexed all of us. We have done little except to put it off for a good number of years that I have been here and add to the benefits. I voted against some of those benefits. The only idea is we had to pay for them and we didn't have the money to pay for them.

You say as I understand it that you think, we need not go into this further unless you wish, it boils down to the fact you think that balancing up this matter has got to come through some increased taxation. Is that correct?

Mr. GREENSPAN. No; I wouldn't say so, Senator.

Senator STENNIS. How did you express that?

Mr. GREENSPAN. Actually, it is a very tough choice in the sense that I would much prefer to see most preferably all of the closing of the so-called long term structural deficit come from the expenditure side.

Senator STENNIS. Come from what?

CURBING OF GROWTH IN SPENDING

Mr. GREENSPAN. The expenditure side, curbing the growth of spending. I recognize that this is not a simple process. I think one has to curb all across the board including the defense areas. I do not deny that the more money that is spent on defense the greater the security of this country other things equal. No matter how much waste is involved, I don't deny that if we have two more wings of F–14's, it is better than none. The problem, however, is that the economy is also a critical national security issue. One of the reasons why we were in fact able to maintain the extraordinary technological and therefore strategic advantages for so many years on the Soviet Union is largely the result of a very productive economic system. As a consequence, in viewing national security questions it is essential that we look to the health of our overall economic system. Since I would consider large and protracted structural deficits as undermining that I would view all sorts of actions that can improve it. Having said that, having looked at the very detail of both the defense and entitlement programs and nonentitlement and nondefense programs, I find it very difficult to be realistic about what the Congress is likely to do to come away with the expectation that no revenue measures are required.

I must admit that I am leaning toward the least worse tax solution which in my judgment probably is a value added tax, effective some time in the mid-decade.

Senator STENNIS. What tax?

Mr. GREENSPAN. Value added tax, some general consumption tax. I think that we have embarked upon a tremendously large increase in entitlement programs over the last 20 years and that my own judgment is

that we have moved much too fast, much too far. I agree with George Perry, if we are going to do it, let's pay for it.

Senator STENNIS. At the same time we have a system that can't be cast aside. People invested in it. They have been made promises. Part of them are people who are no longer able to take care of themselves. Again, I commend you for your work. I am anxious for the Congress to get into it and take some steps. It has got to be done I think.

The system is necessary. I won't take more time now. Thank you.

Senator RUDMAN. Thank you, Senator Stennis.

Senator McClure?

STRUCTURAL DEFICIT

Senator MCCLURE. Thank you very much, Mr. Chairman.

Dr. Perry, what is the structural deficit?

Mr. PERRY. It is the deficit that would exist if the economy were operating at high employment levels.

Senator MCCLURE. What is driving the deficit now and in the immediate future?

Mr. PERRY. What is making it grow? The rise of defense spending and the reduction in revenues that were legislated in the 1981 legislation are the main things.

GROWTH IN ENTITLEMENT PROGRAMS

Senator MCCLURE. You don't see any growth in the so-called entitlements programs over the next several years?

Mr. PERRY. The projection is for those, for social security and medical care to continue to grow slightly and for other nondefense spending to decline substantially. I am reading off the projections in the budget documents for 1983.

Senator MCCLURE. If the budget is adopted as presented. I am talking about if the budget is not adopted as presented?

Mr. PERRY. I used as my point of reference the Congressional Budget Office projection based on the ongoing programs that Congress has accepted. These are the Congressional Budget Office baseline numbers, Senator. I don't make my own projections.

Senator MCCLURE. Don't they show medicare and medicaid growing at 18 percent a year?

Mr. PERRY. Yes; I think medical care grows noticeably and social security grows slightly.

Senator MCCLURE. Civil service retirement grows?

Mr. PERRY. I believe that is inconsequential.

Senator MCCLURE. Military retirement grows?

Mr. PERRY. Yes.

Senator MCCLURE. AFDC grows?

Mr. PERRY. I think that as percentages of gross national product, which is the way these tables are presented, most of those, in fact, do not grow.

Senator MCCLURE. You are looking at a different table than I am then because the average of about 16 percent growth in that group of programs.

Mr. PERRY. I think the table as a whole——

Senator MCCLURE. That 16 percent growth is above the rate of growth in GNP.

Mr. PERRY. That is true. That collection of programs does.

Senator MCCLURE. Isn't that structural deficit?

Mr. PERRY. Yes; that would add to the structural deficit.

STRUCTURAL DEFICIT

Senator MCCLURE. Yet your only answer for the structural deficit is to increase taxes or decrease defense spending. You don't look at the growth in the social welfare income maintenance, income transfer programs as a possibility?

Mr. PERRY. That is certainly a possibility, Senator. I indicated as much in the written testimony. In trying to summarize that, I suggested that there was not very much there compared to possibilities in other areas, that in fact the total of nondefense aside from medical costs and social security is declining considerably already in the projections.

Senator MCCLURE. The total is, but the balance of the entitlement programs is continuing to rise more rapidly than GNP.

Mr. PERRY. I think that is true. But I think the main dollars—I certainly don't disagree—the main dollars are in social security and medical care. The first of those has been addressed already by Alan Greenspan's commission and included in my own estimates here. That leaves medical care as the area of big spending growth which I indicated is a big problem and indeed would be a bigger problem if we projected these numbers another 10 years ahead.

I believe growth in the rest of entitlements is relatively small. But they are certainly candidates for carrying their share of the reductions.

Senator MCCLURE. On page 1 of your testimony, Mr. Greenspan—excuse me. Not page 1. On the top of page 2 you define, you state the level of prices must be proportional to unit money supply, that is, the level of money divided by the level of production. Do you include services in production?

Mr. GREENSPAN. Yes; I do. In fact, what that is is basically an algebraic truism which follows from the fact that income velocity does not have any significant long-term trend. The production figures implied there are the constant dollar gross national product which includes goods and services. The price level that is involved is the implicit price index of the gross national product.

LIQUIDITY IN U.S. CORPORATE ENTERPRISE

Senator MCCLURE. In the next two or three paragraphs on that page you talk about the question of liquidity in the corporate enterprise of America today. There are some who have suggested that one of the problems in this area is certainly economic trends toward which you point but another one is that the more liquid a company becomes or maintains itself the more it is target for a takeover of someone else who will then use its liquidity, siphon it off.

Mr. GREENSPAN. Senator, a company is available for takeover in that respect only if it is judged by the marketplace and the stock market as being a turkey. Because any company which is well run has got appropriate liquidity, will be priced in the marketplace in a manner which will make it possible to take it over but very expensive. I don't think that one should view takeovers per se as either good or bad.

What one should in fact argue for is a market system which as best as it can tries to appraise values so we don't get mergers and takeovers of a form which probably are based upon short-term inappropriate pricing. I would not in and of itself argue that a company that is liquid, whose balance sheet is fine is necessarily in such a condition. In fact I would argue that it is they who are more in the position of doing the taking over than the reverse.

FUTURE DEFENSE SPENDING

Senator MCCLURE. Dr. Perry, you have indicated that defense seems to be the place where you can get big dollars in future spending. If Congress should elect to increase defense spending on the path that has been suggested and offset it by cuts in the entitlements programs would that have had the same economic effect as the path you are suggesting?

Mr. PERRY. Yes; as a first appropriation, we should think of a dollar as a dollar in the budget.

Senator MCCLURE. So your suggestion is not necessarily one of economic choice. It is a question of your judgment of what is politically or socially acceptable or doable?

Mr. PERRY. The only point I was trying to make, Senator, was we should reduce the deficits and in doing so I don't think the Congress should feel constrained that there is an economic law at work directing us to reduce it in a particular way. In particular, there is no reason to believe that if we want all the spending that is now being proposed, we should not finance that spending by raising revenues.

Senator MCCLURE. But on the other side, there is no reason an economist could offer a reason why we should not reduce the deficit by cutting spending?

Mr. PERRY. Certainly not. I thought I was clear on that point.

INCREASED REVENUES

Senator MCCLURE. If I look at all your statement, it came out kind of on the order that your judgment was we ought to raise revenues, we ought not to reduce expenditures.

Mr. PERRY. It was. I did suggest that the idea that nondefense spending was on a runaway course not supported by my reading of the evidence. How big it should be is a political judgment. We can have what we are willing to pay for, and that includes the nondefense area, social security as well as defense.

Senator MCCLURE. Also from an economic standpoint, we would not damage the economy even in your view if we elected instead of raising revenues we cut expenditures.

Mr. PERRY. Certainly, as a matter of just the dollars involved.

RELATIONSHIP BETWEEN INFLATION AND PRODUCTIVITY

Senator MCCLURE. What is your view, Dr. Perry, about the relationship between inflation and productivity?

Mr. PERRY. I don't think that productivity is the heart of the answer. Productivity growth helps, but it helps only a little bit. The way it helps is that any increase in costs, say, in wage costs, translates into less of a price increase if productivity growth accompanies it.

In that sense, productivity growth is desirable in terms of both economic welfare and in terms of fighting inflation. But the effect in terms of inflation fighting is very small.

Senator MCCLURE. Let me ask the question in absolutely a different fashion.

If a country consumes more than it produces over a long period of time, what happens to the rate of inflation or does it have any relationship to the rate of inflation?

Mr. PERRY. As you pose that I don't believe it can be done. It can be done by running a trade deficit and therefore consuming things which are produced abroad. But apart from that, I am not sure I understood the question.

NATIONAL DEBT

Senator MCCLURE. Can it consume more than it produces by running up a national debt?

Mr. PERRY. No; that would not cause it to consume more than it produces. All that is available at any moment in time is the gross national product. The national deficit would influence what was produced and how it was paid for. But that production is going to be the gross national product.

If you have in mind, Senator, whether having more investment is desirable in the long run, I would agree that it is and it calls for reducing the Government deficit other things being equal.

I think that is the way to encourage more investment and, therefore, some improvement in future output.

Senator MCCLURE. Dr. Greenspan?

Mr. GREENSPAN. I would agree with that. Technically, Senator, you can increase consumption temporarily by increasing Government debt. The obvious case is to print money and buy goods from abroad. However, you will very rapidly find that the exchange rate of the currency will collapse and that is a very limited endeavor ultimately.

There is no way out of that box. My assumption is the same as what George Perry said on the issue.

Senator MCCLURE. If that is true, financing, increasing debt buying more than you produce, why don't we simply buy more than we produce, raise our standard of living by buying more than we produce?

FOREIGN DEBT INCREASES

Mr. PERRY. We are talking about increasing foreign debt. Many countries, at different stages of their development, buy from abroad more than they sell abroad. In that sense, you can consume in this year more than you produce domestically.

As Allen Greenspan said——

Senator MCCLURE. You can consume more than you paid for even if it is domestic.

Mr. PERRY. I would not agree with that formulation.

Senator MCCLURE. You don't think you could consume more than you pay for?

Mr. PERRY. No; everything, if we imagine a closed economy, everything that is produced——

Senator MCCLURE. Can you personally consume more than you produce?

Mr. PERRY. Sure.

Senator MCCLURE. Can your Brookings Institute consume more than it produces?

Mr. PERRY. It has a very limited ability to borrow.

Senator MCCLURE. Can a business do it?

Mr. PERRY. I think you asked the question in just the right way. I can do that, a business can do that because our relationship to the economy as a whole is parallel to the United States relationship to the world as a whole. So just as the United States can do what we are describing, run a trade deficit, I can run a trade deficit.

TRADE DEFICITS

A company can run a trade deficit. But you need a larger universe against which to do that.

Senator MCCLURE. You see that is something I find very difficult to accept is the idea that you run up that debt, that doesn't have a measurement of stimulation of consumption. There is a relationship somewhere between productivity and expenditure. It is in your own economy or in your own personal economy or in a business balance sheet or in a country's balance sheet.

Mr. GREENSPAN. Senator, I think what you probably allude to is the fact that if the Federal debt becomes inordinately large relative to the economy, somebody has got to hold that debt.

Basically, it is claims against goods and services. In the very abstract sense, what a price is is a relationship between the amount of purchasing power or chits or currency that can be used to buy goods and services and the amount of goods and services that is there. So I do think that one can argue that if you allow the level of Federal debt to rise to a point where in effect you have directly or indirectly, depending on how it is financed, claims on the system which are increasing at a rate faster than goods are being produced, then you are almost surely going to get an inflation which has the secondary consequences of economic disruption.

There is no way to consume more than you produce unless there is somebody out there who is producing more than they consume and is willing to either give it to you or lend it to you. There is no other way to do it.

Senator MCCLURE. Unless the Government prints the money that is the substitution or creates the means of a change that is the substitution for somebody else giving up something.

Mr. GREENSPAN. Provided somebody is willing to believe that that claim has a fixed value which is really what the problem usually is, is that you couldn't put claims to a fixed quantity of goods.

For example, obviously the case where you just double the number of claims, the initial claimants thought that their claims were worth one unit apiece, if you double the claims, all of a sudden they are now worth half that. But often it takes time before one is aware of that.

Senator MCCLURE. I would agree with both of you that certainly in the abstract you cannot consume more than you produce, that means if somebody, if one consumes something you have to find somebody that forgoes consumption because they provide the financing for the consumption out of the fact that they produce more than they consume. But a monetary system that is built upon the expansion of debt can foil that system for awhile, even without running a deficit and balance of payments just as you individually or Brookings Institution or your company or our Congress or the Senate can spend more money than it has for awhile by running up debt, because somebody else finances it and in this instance, the Federal Government owns the printing presses.

The Federal institutions have a great effect upon how much medium of exchange is in being at one time. That medium of exchange can inflate that expectation that can fool that expectation that productivity and consumption are rising hand in hand.

Then you have the choice ultimately of how you finance that debt, either by inducing other people within the society, consuming more than they produce and thus use their excess earnings to finance that debt.

Is that not correct?

Mr. GREENSPAN. Senator, there is no way as you point out that you can consume more than you produce and if you think of all the financial claims, whether it be currency, money, debt instruments, stocks or what, all they do is act as a structure of claimants which enable you to have claims in the generic sense on goods and services. But ultimately everything must balance, including the willingness of your debtors who are lending you goods and services temporarily to hold your paper.

One of the problems is that if the Federal Government has no such problem, it mandates claims as legal tender. It is a legal issue that we must hold that, must accept that. Regrettably the rest of us don't have that luxury.

FEDERAL GOVERNMENT MARKET SECURITIES

Senator MCCLURE. The Federal Government also has something else. It goes to the market and offers various securities for sale. We pay whatever the bid price is because there is no balance sheet.

Mr. GREENSPAN. Ultimately, the reason they are able to do that is that they have the ability to enforce the acceptance of those instruments in payments of goods and services.

If the statute did not provide that, you would find that no matter what you could produce, you could not sell a Treasury issue unless that attachment were there.

Senator MCCLURE. Dr. Perry, does there come a point in taxation where people begin to make choices on the basis of the after tax rewards of labor as against leisure?

Mr. PERRY. Yes; I think that exists at all points in time.

HIGHER TAXATION LEVELS

Senator MCCLURE. What you see as the levels of taxation in the United States as compared to the levels of taxation in other countries is that only a relatively few Americans would make that choice, higher levels of taxation?

Mr. PERRY. The evidence is that a good many decisions about how you earn your income are based on the choice of how it gets taxed. I think that is one of the problems with our tax system. It leads to a great deal of tax avoidance. People go way out of their way to find a way of getting their income to a lower income tax bracket category. But in terms of total effort, therefore total gross national product, there is not evidence that our tax rates are having any bad effect. Indeed, our tax rates today are a good deal lower than they have been in much of our history. You had a 90-percent top rate, then a 70-percent top rate, now a 50-percent top rate.

Senator MCCLURE. That affects very few people, those top rates.

Mr. PERRY. Those are the places where we usually look. The higher the rate the more likely there is to be a disincentive effect.

Senator MCCLURE. I understand that. But how about a sawmillworker in Idaho who is suddenly sick every Friday afternoon, his employer is asking him why, he said I was sick the first Friday afternoon, but when I got my check for that week, it was only a few dollars less.

Frankly, my Friday afternoons are worth more to me than that number of dollars. He was making a choice that that Friday afternoon leisure was worth more to him than the after tax for his returns on his productive labor.

That is not a high rate of taxation. That is a median level workingman, hardhat, probably Democrat, in my State, that made that choice.

Do you think that is relatively insignificant, not enough for us to worry about?

Mr. PERRY. Yes; I do. But I think it would be desirable to have a broader tax base and, therefore, lower rates. There is no question that that is the direction in which we would like to go. That is quite separate from the total amount of revenues we need.

Senator MCCLURE. A broader taxation, you would have less exemptions in a lower rate and fewer tax shelters in the lower rate.

Mr. PERRY. That is right.

Senator MCCLURE. So that the people in the upper end or the lower end see a smaller proportion of their total being taken by their taxes, that means somebody else, that that would be a tax shift, would it not? It wouldn't increase the aggregate amount of taxes paid?

Mr. PERRY. It would address the problem that you were asking about—whether a high tax rate could possibly have a disincentive effect. It would be more equitable by most people's view of equity.

Senator MCCLURE. I am not sure that this question of disincentive is purely one of equity.

FLAT TAX RATE

Mr. PERRY. No; I was distinguishing it. I said if we could imagine starting all over again, having income from all sources taxed comparably, we might think of that as being a fair tax system and that would also permit lower tax rates at any level.

Senator MCCLURE. Income from all sources, no deductions or exemptions, uniform flat tax?

Mr. PERRY. There have been a lot of proposals along those lines. It need not be a flat tax rate.

Senator MCCLURE. That is going to shift the burden somewhere?

Mr. PERRY. Yes.

Senator MCCLURE. It will include people in tax payments that are not now included in order to reduce the rate on others who are now included.

Mr. PERRY. In practice it would, of course. In principle, it need not. It could simply mean lower marginal tax rates. We could all be in exactly the same situation, all utilizing exactly the same loopholes, taking the exact same means of tax avoidance.

We could all be in identical situations and still change the tax law in such a way that everybody's marginal rate was lower and we simply included everything in income rather than only a limited amount of things that now are included in taxable income.

It is not simply a matter of changing it around between people who have managed to find ways of sheltering and people who have not been able to. By and large, of course, you know the wage and salary workers are not in a position to shelter income relative to others.

STATUS OF MIDDLE-INCOME TAXPAYER

Senator MCCLURE. Somebody said, the very rich and the very poor do very well in our system. The guy in the middle gets caught. I guess that is an accurate summary.

I am fascinated by this. I will not pursue it any further. But I think maybe I perceive in your testimony the classic debate which I think really is the one going on in the Congress, most people in the country don't understand it, that is between those reduced steps by increasing taxes and those increased deficits by increasing expenditures.

I think you two fall very neatly on the two sides of that divider if I understand your statements correctly.

Dr. Greenspan, Dr. Perry, we thank you very much for your testimony.

CONCLUSION OF HEARINGS

This hearing concludes the economic outlook hearings of the Senate Appropriations Committee and the committee will stand in recess and reconvene at the call of the Chairman.

[Whereupon, at 12:15 p.m., Tuesday, February 22, the hearings were concluded, and the committee was recessed, to reconvene at the call of the Chair.]

SUBJECT INDEX

CONGRESSIONAL BUDGET OFFICE

Page

Administration budget, reestimate of 115, 119, 120, 132
- Budget program 131
- Outlook 133
- Proposals 129

Baseline budget projections 127
Budget outlook 125
Defense spending 119, 135, 141
Deficit, size of 135, 137, 144
Economic assumptions, CBO and administration comparison of 126
Economic outlook 115, 123
Federal budget deficit 129, 144
Federal Reserve, money activities by 141
Interest rates 136
Nondefense discretionary programs 120
Oil, excise tax on 120
- Effect on economy from 140

Outlay growth concentration, areas of 117
Policy assumptions 116, 118
Short-run forecast, table on 124
Social Security reform 119, 138
Unemployment rates 142

DEPARTMENT OF THE TREASURY

SECRETARY OF THE TREASURY

All-savers provision, results from 42
Balanced budget, administration plan for 59
Bearer bonds 45
Budget proposals 19
- Freeze 36
- Greatest increases in 59

Capital gains 52
Charts and illustrations:
- Contributions to typical recovery by real GNP component 25
- Deficit as share of GNP 27
- Interest rates and inflation 22
- Interest rates—weekly average 23
- The path of postwar economic recoveries 24
- Unified budget receipts as percent of GNP 26

Defense spending 57, 72
Deficit reduction program 5, 22, 41
Developing countries loan defaults 28
Economic structure, policies for changes in 14
- Fiscal policy 15
- Monetary policy 15

Economic upturn, signals of 3, 10, 12

	Page
Economy:	
Administration goals for	11
Current state of	11
Cycles, change in	35
Outlook for	4, 13, 28
Education, problems in	33
Elderly, exemptions for	44
Employment, future deficits effect on	60
Enterprise zones	43
Federal borrowing practices	69
Federal debt, effect on economy of	31, 70
Food and farm prices, increase in	56
Foreign loans, U.S. leverage over	47
Government growth	35
Industrialized nations, close U.S. ties with	8
Inflation, reductions in	66
International debt	46
International Monetary Fund, U.S. increased participation in	9
Interest rates, further reductions in	31, 42, 61
Inventory restocking	65
IRA and Keough plans	42, 46
Labor costs	29
Monetary policy	66
Oil, effect on economy from	64
Personal savings	48
Peterson Group, reduced deficits recommended by	63
PIK program	55
Real wages and productivity	67
Receipts, growth rate of	20
Recovery:	
Policies for	14
Signs of	4, 10, 12
Retirement COLA's	7, 17
Safe Harbor Leasing Provision, GE profits from	51
Service and information economy, trend toward	29
Taxes:	
Budget initiatives	7
Capital spending, impact of tax cut on	39
Code simplification	67
Contingency tax plan	8, 21
Fringe benefit tax	37
Indexing	6, 17
Owed taxes, collection of	44
Policy on	36
Reduction—1981	5, 16, 38, 50
Small businesses, effect on	7, 17
Third-year cut	38, 48, 53
Trigger tax	37
Wall Street, effect on, from eliminating third-year cut	40
Withholding	54
Trade deficit	55, 72
Tuition tax credits	53
Unemployment, high figures on	28, 65
Unified budget receipts	5
Venture capital	49
White House conference on transition, suggestion for	30
Withholding and savings certificates	43

EXECUTIVE OFFICE OF THE PRESIDENT

PRESIDENT'S COUNCIL OF ECONOMIC ADVISORS

Page

All-savers certificates ... 108
Budget deficit ... 83, 93
  Reductions ... 99, 108
Corporate and business liquidity ... 106
Debt, servicing of ... 99
Economy:
  Administration forecast on ... 78, 85
  Future forecast ... 78, 94
  Policy on, congressional contributions to ... 77
  Recovery, leading indicators in ... 79
Employment, increases in ... 80
Expansion programs, open market financing of ... 106
Federal debt, dangers in rise of ... 112
Federal Reserve, actions on monetary controls by ... 111
Financial markets and international economy ... 81
Industrial production, statistics on ... 81
Interest rates ... 81, 102, 105, 107
International economic conditions ... 82, 92
  Debt situation ... 83, 109
Monetary conditions and financial markets ... 89
Program administration, cost savings and improvements in ... 103
Private savings ... 105
Public works programs ... 111
Real money stock ... 82, 91
Recovery, factors limiting ... 113
Spending programs, reduction of ... 101
Taxes:
  Collections ... 100
  Decrease, postponement of ... 102
Trade deficits ... 83
Unemployment situation:
  Statistics on ... 79
  Trends ... 111
U.S. bank loans to foreign countries, oversight of ... 110

NONDEPARTMENTAL WITNESSES

THE BROOKINGS INSTITUTION

Debt, interest payments on ... 254
Defense spending ... 262
Economic recovery, speed of ... 252
Entitlement programs ... 256, 260
Federal market securities ... 265
Foreign debt increases ... 264
Growth in spending, curbing of ... 259
Inflation and productivity, relationship between ... 263
Medical care ... 254
Monetary policy versus inflationary factors ... 258
Outyear deficit reductions ... 253
Revenues, increase of ... 262
Social security:
  Increases ... 254
  Recommendations ... 259
Special tax provision exemptions, elimination of ... 255
Structural and cyclical deficits ... 241, 252, 260, 261
  Alternatives for reduction in ... 246
  Budgetary policy challenge ... 243

Structural and cyclical deficits—Continued Page
Future impacts from ... 245
Recovery, aiding of ... 244
Taxation ... 253
Flat rate ... 267
High levels of ... 266
Middle-income group, status of ... 267
Third-stage tax cut, cancellation of ... 255
Trade deficits ... 264
U.S. corporate enterprise, liquidity in ... 261
Velocity growth ... 257

TOWNSEND-GREENSPAN, INC.

Business balance sheets ... 239
Economic recovery, upturn in ... 237
Interest rates ... 238
International financial system ... 239
Metal prices, increase in ... 237
Money supply growth, increase in ... 238
Production and new orders, recovery in ... 238
Trade protectionism ... 240

OFFICE OF MANAGEMENT AND BUDGET

Agriculture:
Loan programs ... 211
Nutrition programs ... 212
Anti-cigarette smuggling program ... 234
Budget:
Appropriated portions of ... 151
Controllability of ... 153, 207
Economic assumptions underlying ... 204
1984 freeze ... 154
Pro forma authority of ... 154
Proposals, balanced package of ... 220
Civilian and military pay, freeze on ... 196
Credit, Federal absorption of ... 196
Cumulative total debt ... 210
Debt collection ... 220
Department of Defense:
Acquisition initiatives ... 224
Cost overruns, reporting requirements on ... 225
Economical production rates ... 225
Procurement slow-down ... 224
Economic and fiscal issues, charts document on:
Part I:
Aggregate freeze on nondefense discretionary programs ... 160
Budget impact of discretionary program freeze ... 161
Budget totals—President's budget freeze and reform plan ... 157
Changes in tax burden as share of GNP ... 168
Defense outlays as share of GNP ... 169
Domestic program increases in fiscal year 1984 budget ... 162
Fiscal economic impact at a glance ... 166
Four-point budget freeze and reform plan ... 158, 159
Funding for public infrastructure ... 165
More adequate funding for law enforcement ... 164
Nondefense spending as a share of GNP ... 167
Recognition of key congressional priorities—1984 budget ... 163
Part II:
Budget authority transactions that do not affect annually funded discretionary programs ... 176

Economic and fiscal issues, charts document on—Continued
Part II—Continued — Page
Budget totals for appropriated entitlements—1984 ... 174
Fiscal year 1984 budget totals for appropriate programs ... 171
Major entitlement changes affecting committee jurisdiction matters ... 172
President's request for annually funded discretionaries: comparison to 1983 enacted bills ... 180
Relation to discretionary programs not funded through appropriations process ... 178
Relationship between total appropriations request and request for annually funded discretionaries ... 177
Requests pending before Appropriations Committee ... 170
Part III:
Budget priorities shift in historical perspective ... 192
Defense and security programs ... 189
Defense share of budget ... 193
DOD budget, 1983–88 ... 191
Entitlements, statutory changes in ... 202
Federal borrowing ... 219
Federal trust funds, acceleration of obligations from ... 209
Fiscal 1985 target deficit ... 219
Food stamp program, administration of ... 215
Foreign assistance levels ... 226
Gross national product, budget share of ... 152
Growth figures, effect on receipts of larger ... 202
Health care reforms ... 198
Inflation rate—fiscal year 1984 ... 196
International Monetary Fund, quota increase for ... 227
International trade program ... 235
Jobs program, creation of ... 200, 216
Mass transit, operating assistance for ... 208, 232
National Bureau of Standards, scientific and research funding for ... 228
National Oceanic and Atmospheric Administration, scientific and research funding for ... 228
National Science Foundation, scientific and research funding for ... 228
Oil prices:
Drop in, economic effects of ... 201
Effect on budget from ... 197
Outer Continental Shelf oil and gas receipts for 1983 ... 222
Outlays, receipts, and deficits, important points regarding ... 150
Private savings versus credit market flows ... 206
Property review board specifics ... 223
Public infrastructure spending ... 152
Six-year real GNP growth forecast compared to historical recovery cycle experience, chart on ... 205
Small businesses and farmers, Federal credit for ... 230
Social security estimates ... 198
Standard level user charge (SLUC) ... 229, 234
Tax burden, increase of ... 202
Treasury enforcement staff ... 233
User fees ... 231